

Marketing communication

Mind the gap

01 October 2020

Monthly Outlook



For economies it's literally been a rollercoaster, from the blissful ignorance and denial of the first quarter, to the lockdowns and economic implosion in Q2, and the reversal of restrictions fuelling a rebound in economic activity in Q3. Note this rebound, while impressive, was partially mathematical in nature. Consider this: when economic activity plunges 30% in one period, and subsequently goes up 30% in the next period, you aren't back where you started.

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We're now in the final quarter of a year many of us would quickly like to forget. I could particularly relate to the FFWD 2020 t-shirts that have popped up.

For economies it's literally been a rollercoaster, from the blissful ignorance and denial of the first quarter, to the lockdowns and economic implosion in the second quarter, and the reversal of restrictions fuelling a rebound in economic activity in the third quarter. Note this economic rebound, while impressive, was partially mathematical in nature. Consider this: when economic activity plunges 30% in one period, and subsequently goes up 30% in the next period, you aren't back where you started; you're still 9 percentage points down from where you started.

Unfortunately the fourth quarter also comes with renewed virus challenges. In many countries where the curve had been flattened earlier in the year, new cases are now on the rise, deaths are creeping higher and ICU capacity is once again filling up.

Hopes of an imminent arrival of a vaccine have seemingly receded along with the summer weather in the Northern hemisphere. As far as we can gauge, many trials still appear to be progressing satisfactorily, which would fit our base case scenario in which a vaccine will arrive over the course of 2021H1 and should start to make a material difference from the third quarter of 2021 onwards. Improved treatment plans should also reduce overall mortality and hopefully keep ICU capacity better manageable, alongside the inevitable ongoing restrictions and better testing. But that's a lot of references to "hope", where people obviously desire certainty and clear timelines instead.

The realization that we –economically speaking– might have to bridge another 6 months or more before a vaccine can offer substantial relief should weigh heavily on activity in the near term. Particularly as we may face some fatigue in terms of offsetting stimulus measures. Monetary policy will remain extremely accommodative, but can only do so much as central bankers keep asking politicians to take over and use historic lows in interest rates to deliver more fiscal stimulus. The latter is proving challenging in many countries though as the crisis stretches on and fiscal deficits and government debt balloon.

Unfortunately Covid-19 isn't the only challenge to deal with. Geopolitical tensions are still flaring up in diverse places, unimpeded by the virus. Brexit negotiations are hardly moving smoothly, and the avoidance of a "Hard Brexit" isn't assured; sobering thought: even an actual deal would be far less ambitious than many initially thought when the Brexit vote first occurred. Meanwhile the US elections are about a month away and are taking place in a highly polarized landscape, offering plenty of additional uncertainty, and hence headwinds for an embattled economy.

So let's buckle up for the Helix!

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Fixed Income

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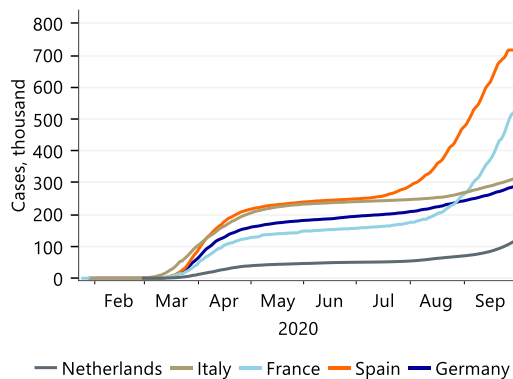
Markets on novocaine

As I write these pages, the Dutch government has just introduced new measures to help prevent the spreading of the Covid-19 virus as the number of diagnosed cases has started to rise again, especially in parts of the country. And the Netherlands are not alone in this. In various parts of Europe, the daily rate at which confirmed cases are added is increasing. While part of this increase may be due to increased testing, the virus also appears to be making a resurgence.

The increase in cases, and measures to once again try to flatten the curve, remain big risks to the recovery ahead. Firstly, government measures –while not (yet) as stringent as the full lockdowns seen in the first half of the year– will continue to stifle activity in specific sectors. National fiscal aid packages are still in place, but in most of Europe, governments have begun to reduce the scale and scope of the economic support provided. Secondly, consumers can be expected to exercise caution in the months ahead. Even though there are no full lockdowns in place, self-isolation will continue as people want to avoid catching or spreading the virus. Moreover, as fiscal support becomes less generous, more businesses may struggle to keep all staff on the payroll. So consumer demand will continue to be slowed by precautionary saving, or in the worst case a loss of jobs and incomes.

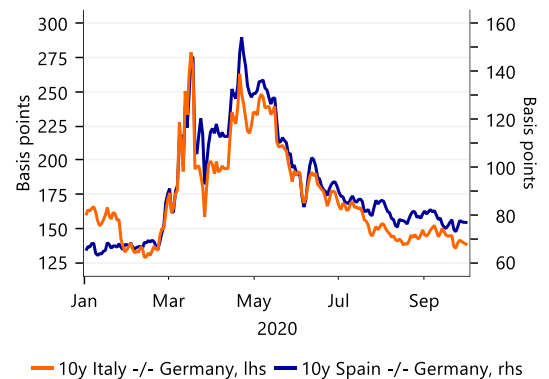
Therefore, this Covid-19 resurgence creates downside risks for GDP growth on one hand. On the other, it also continues to put pressure on government expenditures. Even if Eurozone governments continue their trend of continued, but less generous, fiscal support, non-discretionary spending may then increase if layoffs lead to a bigger recourse to unemployment benefits. At the same time, a reduction in private income continues to weigh on tax revenues.

Figure 1: This is not looking up...



Source: World Health Organisation

Figure 2: But sovereign markets remain sanguine

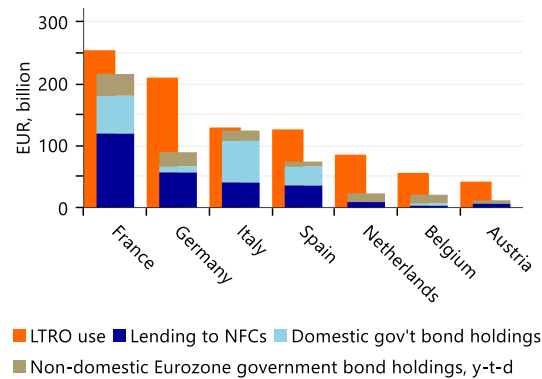


Source: Bloomberg

And all of this comes after public finances across the continent already took big hits when governments shut down economies and implemented large-scale stimulus to mitigate the effects of putting their countries in hibernation. Nevertheless, you wouldn't guess this when looking at the developments in fixed income space.

Of course, this is to a large extent driven by the ECB's liquidity provision. The asset purchase programmes continue unabated, and the PEPP envelope remains half-full. In addition to this, banks borrowed a bumper EUR 1,300bn from the ECB in TLTRO-III.4, and the ECB allotted another EUR 175bn to banks last month. Accounting for repayments of earlier loans, ECB lending to banks has increased by EUR 1,100bn year-to-date.

Figure 3: Estimated use of TLTROs, year-to-date



Source: ECB, Rabobank

And while TLTRO-III includes incentives to encourage banks to lend this money on to the real economy (i.e. businesses), evidence suggests that only part of this liquidity has actually been used for such purposes. French banks top this estimate, with their lending to non-financial corporations increasing by about half of their TLTRO-borrowing, year-to-date. Instead, the data suggests that much of this borrowing has been used by banks to purchase domestic government bonds, particularly in the periphery and in France. Unsurprisingly, this has happened to a much lesser extent in

Germany and the Netherlands, despite large demand for TLTRO-III. After all, the yield pick-up of their domestic bonds is much smaller. Indeed, we do see some increase in bank exposure to the debt issued by other Eurozone governments; most likely peripheral countries.

Therefore, TLTRO-III has probably further supported the continued spread tightening in the Eurozone government bond space, despite the recent news flow adding to the risk that fiscal balances will deteriorate further. So while we are still waiting for the successful development of a Covid-19 vaccine to decisively put the economy on a trajectory of recovery, the ECB continues to keep administering novocaine to markets.

Stuck in a hole and still digging?

Crucially, this also means that the combined set of ECB policies remains a key factor limiting the impact of ballooning public debt and deteriorating fiscal metrics. And while the inflation outlook doesn't exactly warrant any such considerations at this juncture, reversing these policies could cause markets to put more weight on the different fiscal metrics – thereby putting more emphasis on fragmentation risk again. That could affect the ECB's exit strategy.

President Lagarde recently acknowledged such risks. In the current environment, goals of monetary and fiscal policy are aligned. However, *"if monetary and fiscal policies are interacting more closely, it also raises important questions – questions that will become even more acute in the aftermath of the pandemic. These include how to set policy in a world of possibly permanently higher levels of public debt, and the appropriate design of Europe's fiscal framework."*

As we have learned from the previous crisis, returning to austerity too quickly after the pandemic is over would not be advisable. At the same time, despite an agreement on a European fiscal package, appetite for further steps towards debt mutualisation remains low. So it may take quite a while for fiscal metrics to improve substantially again – especially in peripheral countries, which had a weaker starting point heading into the pandemic. Against this background –and again also taking into account the inflation outlook– the ECB is likely to remain accommodative for a long time.

Table 1: EUR swap rate forecasts

	1 Oct	+3m	+6m	+12m
2y EUR swap	-0.49	-0.40	-0.40	-0.50
5y EUR swap	-0.42	-0.35	-0.40	-0.50
10y EUR swap	-0.22	-0.10	-0.20	-0.20
30y EUR swap	0.00	-0.05	-0.10	-0.05

Source: Rabobank

Foreign Exchange: Majors

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EUR/USD: testing the water?

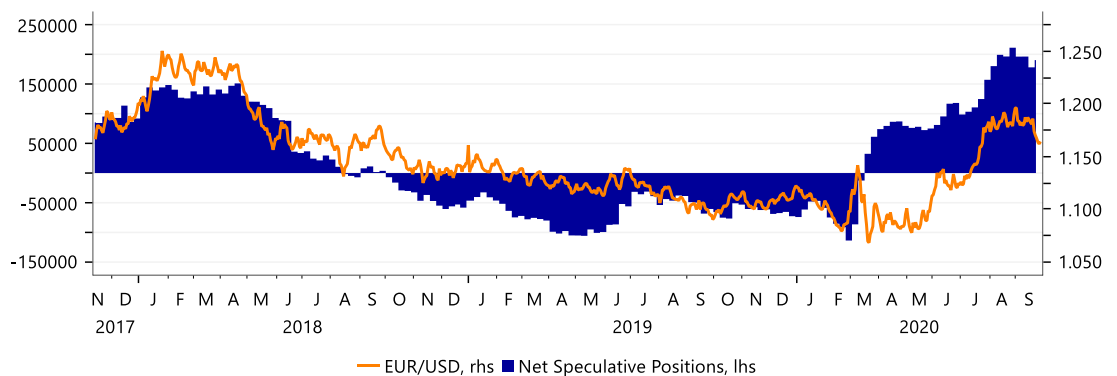
The mid-September correction in EUR/USD was likely driven by several factors. Firstly, long EUR positions were appearing over-extended given growing concerns about the risk of a second wave of Covid-19 in Europe. Secondly, investors were also likely questioning whether the build-up in USD shorts through the summer was appropriate given the worsening in fundamental factors and the greenback's safe haven status. We look for EUR/USD to correct lower towards 1.16 on a 3 month view.

As long as the Fed's emergency liquidity measures remain in place, the market is unlikely to come anywhere close to exhibiting the signs of USD shortages that were obvious in March. Even so, there is plenty of scope for the news flow to push investors away from high risk currencies and back into the USD. Some of these risks are economic, such as the possibility that further stimulus from Congress will be slow and disappointing in size. There are also worries about slower medium-term global growth stemming from the continued impact of Covid-19 on trade as the world learns to live with the virus for longer. Other risks are tied to politics, with the November US election having a greater-than-normal potential to trigger market disruption this year.

On December 11, 2000, the US Supreme Court forced an end to the Florida recount and awarded victory in the contested election to Bush. Gore accepted defeat gracefully. If this year's election is contested, it would seem less likely that the defeat would be accepted with pragmatism. Even main street press are speculating that this election could trigger civil unrest. This outcome would almost certainly result in a move toward safe haven currencies including the USD.

Irrespective of who wins the US election, it would appear that suspicion will continue to define the relationship between the US and China. Tensions between China and a host of other countries in the Asian region have also been growing. While USD/JPY may push lower against the backdrop of China tensions, a covering of short positions would likely to result in the greenback rising against a basket of other currencies including the EUR.

Figure 1: CFTC speculators' EUR positions - time to take profits or extend?



AUD/USD: second thoughts?

Our expectation that the greenback can manage a moderate recovery in the coming months leaves the AUD more vulnerable than many other G7 currencies to a correction. Through its links to commodity prices and its strong trading relationship with China, the AUD is sensitive to fears about global growth and to flows in and out of EM. In September the attraction of the AUD also took a hit as the discussion in the market moved towards the possibility of another interest rate cut from the RBA. Having cut rates to 25bp early in the Covid-19 crisis, it had appeared that the RBA initially had little appetite for further moves. In September Deputy Governor Debelle referred

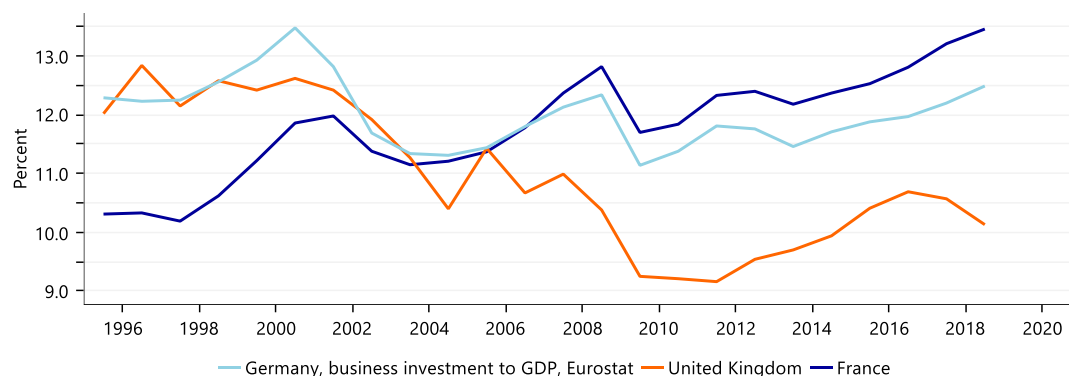
to the possibility of a rate cut that kept rate positive as “possible”. It is conceivable that the RBA could cut rates potentially to 0.1%. Whether or not this happens depends crucially on labour market, wage and price developments in the coming months. However, with so much slack in the global economy, we would judge that such a move could be considered as ‘likely’. Given that the prospect of further RBA policy moves is on the table, the AUD is set to be more sensitive to economic data releases. The RBA policy meeting on October 6 is likely to be insightful. We see scope for AUD/USD to pull back to AUD/USD 0.71 on a 6 month view.

EUR/GBP: dodging minefields?

Having come under pressure in mid-September, the pound managed a late rally at the end of the month. This was built around optimism expressed by both the EU and the UK over the prospects of a Brexit trade deal being made. That said, recent rhetoric has suggested that there is still a lot of distance to cover between the two sides. The implication is even if there is a compromise deal, it may be judged to be lacking detail in certain areas. For this reason, any relief rally may not prove to be extensive. We see scope from a move back to EUR/GBP 0.89 on a 6 month view though this could prove to be an optimistic outlook.

There has been a lot of talk in the market in recent weeks about whether or not sterling hit “peak bearishness” in mid-September. Given the huge degree of political uncertainty faced by the UK in the coming months we would consider it foolhardy to rule out the prospect of further sharp losses for the pound. A no-trade-deal-Brexit and confusion and queues at the border next year, legal action from the EU over PM Johnson’s Internal Markets Act, widespread criticism of government policy over the handling of Covid-19 restrictions, and the prospect of more monetary stimulus are all potential threats for the pound. While Chancellor Sunak’s “winter economic plan” may prevent the UK economy from falling over a cliff-edge at the end of the year, it is unlikely that it can halt a large increase in unemployment. Since concerns are rising about surge in government debt, which pushed above 100% of GDP in July for the first time since 1961, the prospect of negative interest rates from the BoE is set to remain on the table. Although it has become clear that not all members of the MPC would support such a policy measure, some have made their support known. In view of the UK’s current account deficit, GBP could be particularly vulnerable on such an outcome if the political and economic environment in the UK appeared unattractive. While it is not our central view, GBP has the potential to be knocked significantly lower in the coming months.

Figure 3: Business investment as share of GDP



Source: Macrobond

Foreign Exchange: Emerging Markets

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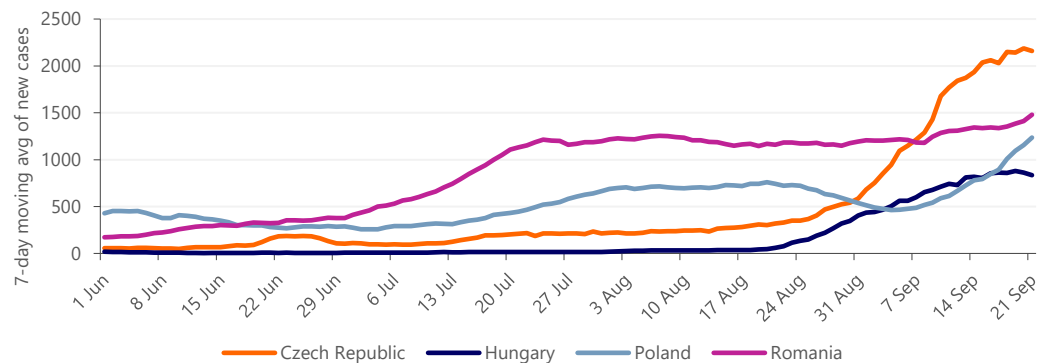
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Central and Eastern Europe becomes coronavirus hotspot

After controlling the Covid-19 pandemic in a relatively effective way in March/April, the Czech Republic, Hungary, Poland and Romania have reported the highest number of daily cases over the last few weeks. The Czech Republic has seen one of the highest infection rates in Europe when adjusted for population. In Hungary active cases have doubled each week in September. An advisor to PM Orban admitted that the real number could be up to 20 times higher due to Hungary's relatively low rate of testing.

Figure 1: Second wave of the coronavirus pandemic hits the CEE region



Source: Bloomberg; Rabobank

With the number of total cases exceeding 120,000, Romania remains the worst affected country in the region. Health Minister Tataru warned that the start of the new school year and the local elections could cause a big spike in daily cases of more than 2,000. Poland was hit hard as well reporting a record high new cases on daily basis in the second half of September.

Essentially, the CEE countries have been engulfed by a second wave of the pandemic which may slow down the pace of recovery after the most severe recession since the communism ended 30 years ago. Throughout September the CEE currencies underperformed their EM peers as the market had to adjust its optimistic expectations for a V-shaped economic recovery in the region.

Will light lockdowns prove enough?

The CEE governments are extremely reluctant to re-impose national lockdowns as their economies are too fragile to cope with another round of severe restrictions. The preference is to rely on not particularly stringent (compared to spring) social distancing rules. Officials seem to be hoping that people will protect themselves and others by adhering to rules such as wearing face masks in public spaces and limiting social interaction as much as possible. While each individual has a role to play in containing the virus, relying on common sense and rational behavior may not prove sufficient to contain the virus without much stricter restrictions.

Even the current, relatively modest constraints may have a negative impact on the hospitality industry. In the Czech Republic rules regarding bars and restaurants have been tightened already. Many European countries have also removed the Czech Republic from their list of safe destinations. Note that Prague is one of the most popular destinations in the EU and thrives on foreign tourists who will be reluctant to travel there as they may have to quarantine themselves for two weeks after they return to their home countries.

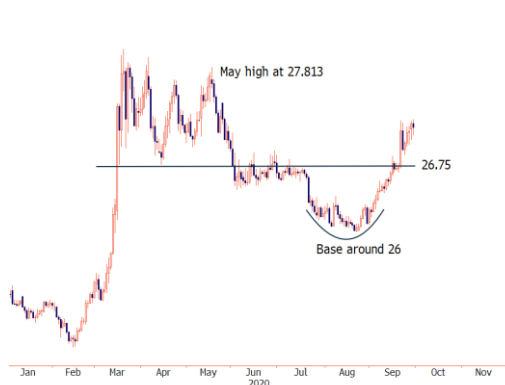
A parabolic rise in infections prompted Hungary to strengthen social distancing rules as well. PM Orban admitted that the current wave may not peak until December/January. Hungary also closed its borders to foreigners again (although the ban does not apply Czechs, Hungarians, Poles and Slovaks). Hungarians returning from abroad have to quarantine for 14 days.

Similar to other countries, the Polish government prefers a targeted approach to contain the virus by imposing stricter limits only in the most affected parts of the country – rather than opting for a national lockdown that would paralyse the economy as it did in spring.

How consumers respond to the growing evidence of another wave of the pandemic will be crucial. It is reasonable to assume that the percentage of Czechs, Hungarians, Romanians and Poles who prefer to stay at home will increase in the coming weeks. After recovering over the summer, private consumption may lose momentum again. And exports are not sufficiently strong to fully offset another fall in domestic demand. Perhaps consumers in the CEE are far more resilient than we assume and they will not change their behaviour substantially during the second wave. However, we find it difficult to believe that a preference to stay cautious and safe will not increase at least until the pace of infections slows down.

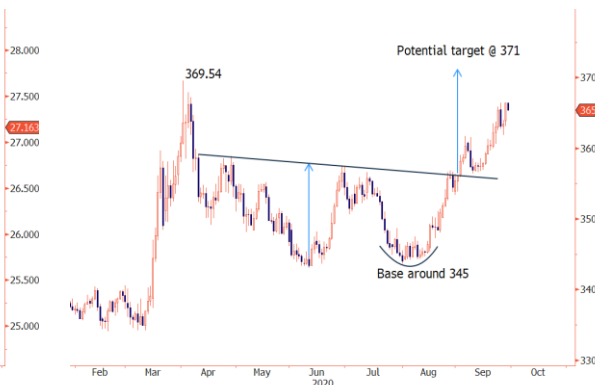
In the coming weeks health experts will be able to assess whether social distancing and mandatory mask wearing are sufficient to control the second wave of the pandemic. If infections continue to rise or accelerate even further, the CEE governments may have to seriously consider much stricter rules at the expense of a slower economic recovery.

Figure 2: EUR/CZK gains upside traction



Source: Rabobank/Bloomberg

Figure 3: EUR/HUF is in a bullish mode



Source: Rabobank/Bloomberg

Apart from the second wave of the coronavirus pandemic, investors are also concerned that redistribution of the vital EUR 750bn recovery fund agreed by the EU could be delayed. Germany proposed to link funds with the rule of law. Poland and Hungary –both accused by the European Commission of undermining democratic standards– have firmly rejected the proposal. Plus, tense trade talks between the EU and the UK and the US presidential election in November have the potential to increase upside pressure on EUR/CEEs and USD/CEEs in the remainder of 2020 as well.

Looking further ahead, when there is sufficient evidence that the second wave of the pandemic has peaked in the CEE region and across the EU, we will be looking for opportunities to establish short positions in EUR/PLN, EUR/HUF and EUR/CZK in line with our view of a sustainable retracement in 2021 when an efficient coronavirus vaccine will allow for return to normality.

Figure 4: EUR/PLN breaks through key technical levels



Source: Rabobank/Bloomberg

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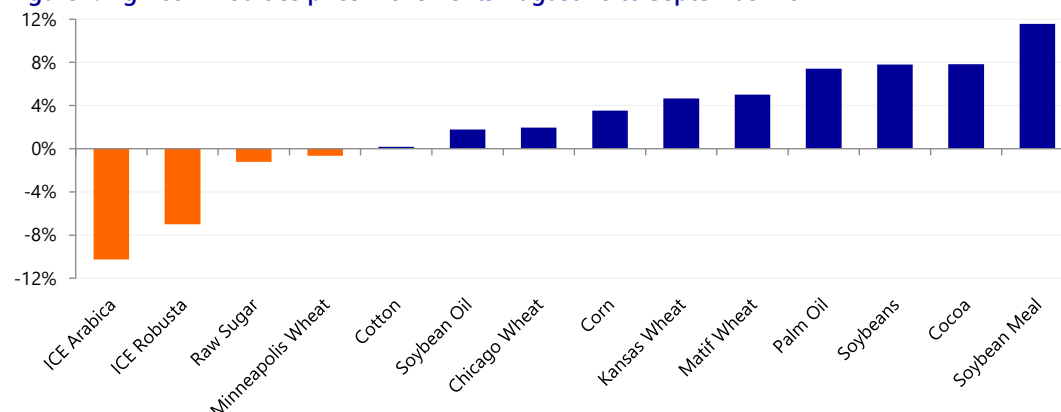
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September 2020: China's Great Food Wall – Made in USA

This month, Chinese buying prompted CBOT G&O prices to reach some of the highest levels in more than two years, despite the incoming US corn and soybean harvests. Weather has been mixed across the globe, as La Niña may cause South American dryness, negatively impacting G&O crops in the region heading into next year. It might also cause wetter-than-normal weather in Australia, aiding the wheat crop recovery. Meanwhile, ICE Arabica has dropped 10% so far in September, as prices correct down to more fundamental levels and realize a record crop in Brazil, while cocoa markets are still digesting the election risk in Côte d'Ivoire.

Figure 1: Agri commodities price movements August 28 to September 28



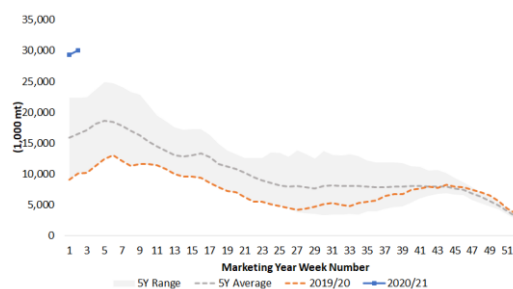
Source: Bloomberg, Rabobank

CBOT Soybeans broke USD 10.00/bu, but easterly trade winds and prices may soon move south

Just like the famous magic beanstalk, CBOT Soybeans enjoyed a rapid rise last month, but there are giants threatening to topple it. The torrent of Chinese purchases of US soy (but also pork and corn) have carried CBOT Soy above USD 10/bu and drawn enthusiastic funds, like Jack, to extend their length near four-year highs. We see both the beanstalk and Jack at risk of a fall. Held up by a temperamental China/US trade relationship, the crowded CBOT Soy trade will be mightily tested by US harvest pressure and the closing US export window. China's intense procurement efforts from the US lead us to raise our nearby forecast to USD 9.70/bu. That is still below current CBOT levels and reflects a US carry-out at pre-trade war, but still manageable, levels of 350 million bushels. US-China soy sales are estimated at around 25mmt, with another 8mmt expected. US crush has extended its record pace (+3mmt increase over old and new crop in five months) to meet higher pork export demand, though Aug NOPA showed signs of cooling (165mbu, -7mbu m/m), amid falling crush margins. Further buoying demand for US summer crops.

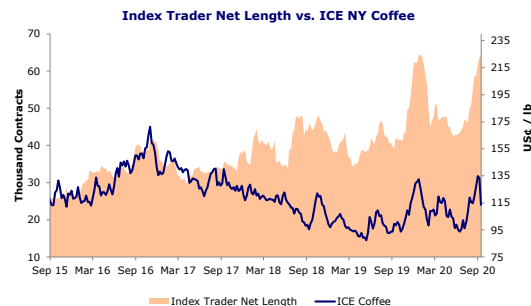
Strong demand across US summer crops, however short-lived, is combining with a smaller-than-normal 2020/21 US acreage to cut stocks and drive risk premiums higher. CBOT Soy is in a rare backwardation and the curve raises questions about immediate tightness in the market, as well as ballooning production expectations next year. In the coming weeks, US farmers will accelerate forward sales of their golden goose even as easterly trade winds begin blowing south. Brazilian farmers, meanwhile, see soy prices at nominal records and are preparing to seed almost 4% more – if it gets planted, expect sales pressure to rise. A potential extension of the dry season, exacerbated by La Niña, could pose planting challenges, especially for Argentina, but yield risks could be offset by higher acreage. In Argentina, good soy prices and higher taxes on byproducts may also pry beans from inflation-fearing farmers, helping to absorb excess global demand.

US farmers are harvesting a front-loaded program to China, demand may slacken in Oct



Source: USDA, Rabobank

Index funds and show appetite for coffee. This will likely prevent a drop to USD 1/lb.



Source: CFTC, Bloomberg, Rabobank

Coffee markets retreated closer to fundamental levels this month, letting go of the previous six weeks' gains

Brazilian warehouses are at maximum capacity following a record harvest, while export pace remains limited. If only 10% of Brazil semi-washed production were to turn up at the exchange, and 50% of that were to pass the grading process, that would push ICE-certified Arabica stocks about 0.35-0.4mn bags higher, to 1.5mn bags. In that case, we could see prices drifting lower. We side with this bearish fundamental view, but caution fund activity has been surprising across ags, and distortions could be expected. The last CFTC, for example, shows that funds continued to buy, even though prices dropped by almost 8% in the week. Furthermore, index funds have been very active. Therefore, we believe that a further price fall to USD 1/lb is unlikely.

The 2020/21 Central American crops continue to be questionable, despite good weather. With the current season nearing an end, total export shipments from Honduras show a -19% y/y decline. The situation is similar in other Central American countries. However, the recent good rainfall and higher prices may mean a better harvest in 2020/21. Still, it will not be without challenges: Covid-19 disruptions and labor shortages could limit the recovery in some countries. The uncertainty will add volatility to Arabica markets in the coming months. Differentials are unlikely to weaken significantly ahead of the harvests, given this uncertainty. However, given the prospects for a good main crop in Colombia and the continuous flow of very good-quality Brazilian coffee, our base assumption is for lower differentials across washed qualities once there is more clarity on the harvest progress (usually around Nov/Dec) and exporters feel more confident selling the crop.

Robusta downside is likely to be much more limited than Arabica, as we see a tightening robusta market. The combined drop in 2020/21 output in Brazil (already harvested) and Vietnam (to be harvested from Nov) will lower availability while robusta demand grows, by clawing share away from Arabica. The ICE Arabica-Robusta spread has returned to much more average levels, at USc 52/lb, after peaking at USc 69/lb in early Sep, and we believe it can continue to fall further, maybe because arabica prices suffer from an influx of Brazil semi washed gradings and/or simply because robusta scarcity becomes more obvious.

CBOT Corn broke into its USD 3.50–4.00/bu-range comfort zone, amid supply concerns that will, at best, offset weak ethanol demand

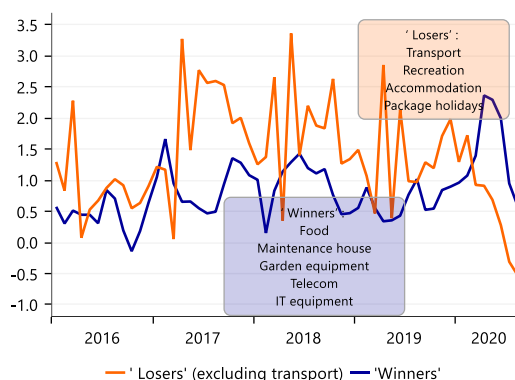
The world's two largest corn harvests –China and the US– were afflicted by declining crop conditions that prevented a golden finish. With the extent of lodging, quality, and yield reductions still uncertain, production expectations in both countries may have dropped by 3-4% in August. These revisions appear modest, but their timing and location have positive ramifications for CBOT Corn after languishing amid expectations of a bumper crop and third consecutive year of demand declines. Those fears receded, due to declines in US acreage and increased Chinese demand. Rabobank sees CBOT Corn's strength increasingly tested by upcoming US harvest pressure and growing acreage expectations for 2021 that will limit gains above USD 3.75/bu.

After a 'careless' summer...

As the spread of Covid-19 receded in the run-up to summer, many European governments eased their regulations for social distancing. After the huge collapse in activity during March and April it was clear that some sectors needed an economic breather despite support measures to limit economic damage. Clearly, the easing of some of those restrictions, notably the re-opening of borders, were also intended to give the battered recreation sector –in some member states extremely dependent on visitors from abroad– some space. To some degree, this worked. As economic support was kept in place throughout the summer months, economic activity improved markedly in the run-up to summer and continued to improve during the early summer months. In fact, the recovery in output in some sectors was even a bit sharper than we had expected.

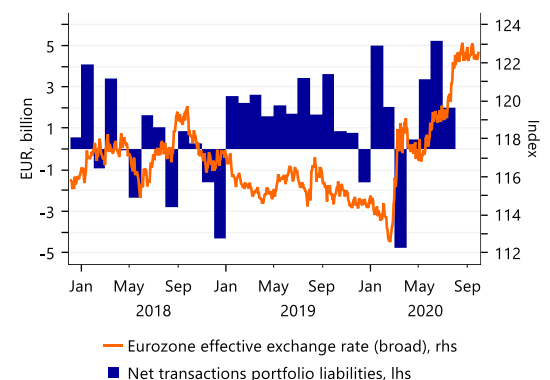
To this should be added that overall sentiment vis-à-vis Europe strongly improved. The handling of the virus spread, the economic support packages and the ECB's measures to get liquidity into the corporate sector proved relatively effective. Crucial also, in that respect, was the swift agreement on the EU budget and EUR 750bn Recovery Fund in mid-July. If we put that into contrast with the (more) chaotic handling of Covid-19 in the US and the state of paralysis on Capitol Hill after the first rescue package, this explains the rise of the euro and the significant inflows into the bloc (figure 2). Indeed, by August the euro had risen to such an extent that it led the ECB to express its concerns with this development. But, of course, the strength of the euro largely was a reflection of the successful approach in the EU combined with the ECB's policy measures. Particularly the large take-up in the very attractive TLTRO-III indicated that banks were not only ploughing this money into the real economy but also into financial markets (again). The Italian spread versus Bunds, for example, fell sharply, thus allowing the country to focus on its domestic challenges rather than on financial market volatility.

Figure 1: Supply and demand in action – as seen from an inflation point of view



Source: Macrobond

Figure 2: Foreign investors have confidence

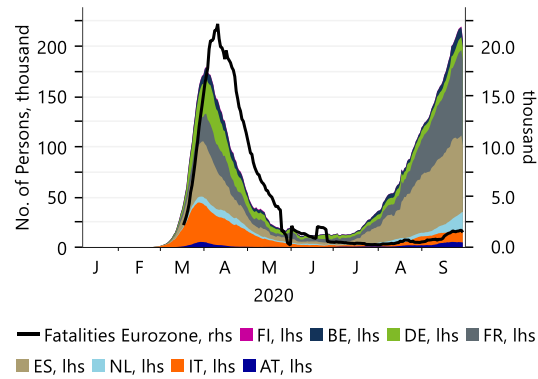


Source: Macrobond

... it's time for that winter depression

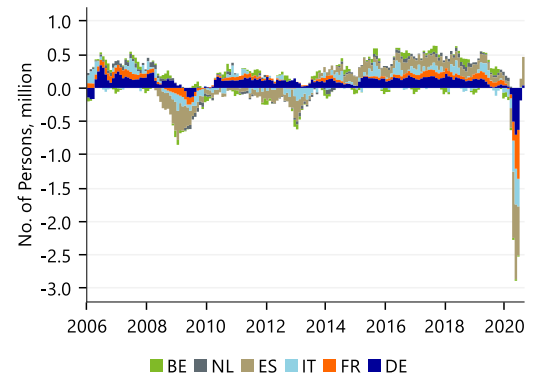
However, as the summer progressed, momentum started to wane. For whilst supply was improving, demand was, unsurprisingly, deteriorating; something that is perhaps best illustrated by the development of prices of certain items. As figure 1 shows, some sectors initially 'benefited' from the lockdown, being able to raise prices as supply was restricted or spending was diverted to other sectors as demand was still 'okay'. However, as demand weakened, the underlying disinflationary development started to overshadowed this. By the end of summer the Eurozone was seeing a consistent weakness in price developments led by weak demand. And with the end of summer comes the inevitable winter depression. The number of new virus cases has rapidly accelerated over the summer months, forcing governments to re-install restrictive measures.

Figure 3: Second wave of sorts



Source: Macrobond

Figure 4: Deeper (but shorter) than 2008-'10: quarterly employment change in EMU-5



Source: Macrobond

This was always in our base scenario but it also implies that after a sharp but technical recovery in Q3, the fourth quarter is likely to prove very different. Although the rise in unemployment so far has been surprisingly muted in most countries, this was mostly due to government support measures. Employment has already taken a serious hit –also when compared to 2008-2009– and it is only now that companies may seriously contemplate restructuring: i) for those who have ran out of liquidity buffers and/or do not have access to additional liquidity (and hence the liquidity problem becomes a solvency problem); and ii) for those firms who are realizing that their business model is no longer appropriate and where this Covid-19 crisis –lasting longer than expected– is becoming a part of the medium-term calculus. Several governments have extended their support measures, but a sobering of these arrangements seems to be a key feature. The EU Recovery Fund still needs to be ratified by member states and some hurdles (such as the discussion on rule of law conditions for obtaining funds under the scheme) need to be taken still. A slight positive q/q growth number remains our base case, but risks to the outlook remain tilted to the downside.

Geopolitics changing rapidly and key risks ahead!

Meanwhile the geopolitical situation in the world isn't exactly improving. [Europe is claiming a more assertive role](#), but we believe that much needs to be done before it can truly carve out a place on the world stage. Until then, it remains highly dependent on its alliances and multilateral institutions. In that respect the outcome of the US elections could be a very important factor shaping the Eurozone's world and outlook. We can almost hear that sigh of relief on Brexit – as we are nearing the end of this teeth-pulling exercise. Limited FTA or no deal at all, it hardly seems to bother anyone. But it still matters, surely for Britain, but also for Europe.

Table 1: Economic forecast

	2019	2020	2021	Q1/20	Q2/20	Q3/20	Q4/20
GDP	1.3	-8.8	4.1	-3.7	-11.8	7.1	0.8
Consumption	1.3	-9.1	5.1	-4.5	-12.4	8.6	1.8
Investment	5.6	-11.4	4.1	-5.2	-17.0	8.0	0.5
Government	1.8	-0.1	2.6	-0.7	-2.6	3.5	1.0
Trade	-0.6	-1.2	0.3	-0.4	-0.6	0.4	-0.3
Inventories	-0.5	0.0	-0.5	0.5	0.1	-0.5	-0.2
CPI (%y-o-y)	1.2	0.4	1.4	1.1	0.2	0.1	0.0
Unemployment rate	7.5	7.9	8.6	7.6	8.8	9.2	9.4

Source: Rabobank

Spain

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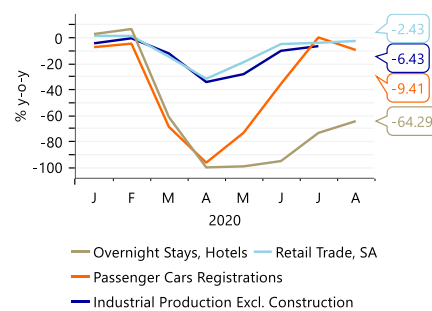
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Q3 will show strong growth

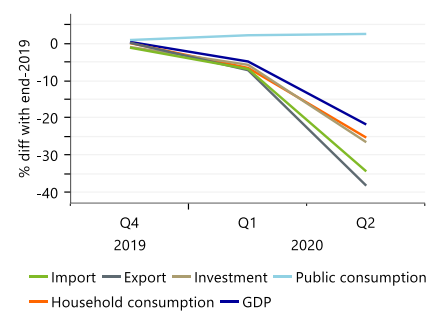
Spain's Q3 GDP figure, to be presented end October, will undoubtedly show that **the economy grew strongly compared to Q2** (figure 1). Mostly because there were much less measures restricting business activity in Q3 than in Q2. Yet based on our growth forecast of 10.5% q/q, **Q3 will not make up for the enormous losses endured in the first half of the year** (-22% compared to end-2019, figure 2). Containment measures were never completely lifted, neither at home nor abroad, and some that were, were reintroduced over the course of Q3. Furthermore, uncertainty about the outlook likely encouraged precautionary savings. On top of that, the rapid increase in virus infections since mid-summer scared off tourists during part of the high season. This is especially costly for an economy in which tourism accounts for almost 15% of GDP, with more than half of the revenue coming from foreign tourist expenditure.

Figure 1: The economy strongly rebounded in Q3, but there is still quite some work to do



Source: Macrobond, Eurostat

Figure 2: Public consumption was the only expenditure component holding up in 20H1

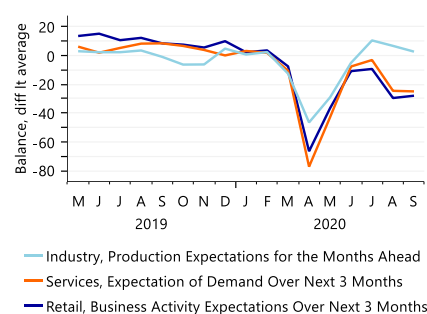


Source: Macrobond, Markit

Limited upward economic potential, without a vaccine

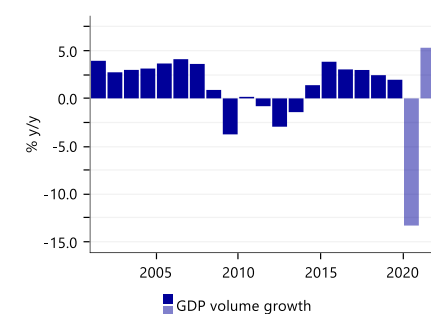
As from Q4, we expect quarterly economic growth to slow substantially, which is underscored by business surveys in August and September, showing that **activity expectations for the months ahead have weakened** (figure 3). We think that economic activity will continue to be hampered by containment measures until a vaccine is widely available. In our baseline scenario this will be the case over the course of 2021. The subsequent removal of containment measures will pave the way for some strong quarters. But still, it will likely take time for demand to return to pre-crisis levels due to job losses and worsened private and [public balance sheets](#). The public budget deficit will reach double digits this year and the debt ratio is expected to reach 125% of GDP. While austerity measures will not be on the agenda any time soon, the government cannot totally neglect its very weak finances. **We forecast GDP to contract with 13.3% this year and to grow with 5.3% in 2021** (figure 4). Due to uncertainty over the timing, amount and destination of EU recovery fund money, its possibly positive impact on growth has not yet been incorporated in our forecast.

Figure 3: Weaker business' activity expectations



Source: Macrobond, RaboResearch

Figure 4: GDP will only partly recover next year



Source: Macrobond, RaboResearch, NiGEM

Government policy is saving jobs, but cannot prevent job destruction

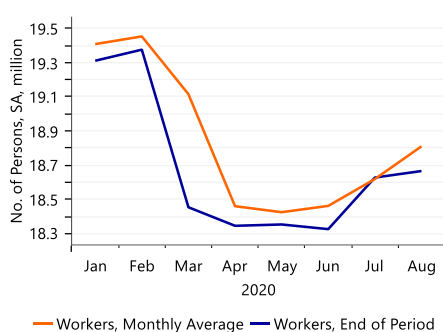
Since April, the government has saved jobs with government support and a ban on layoffs. Yet prior to this fiscal support, in the second half of March almost 900.000 people were let go (figure 5), i.e. about 4.5% of total workers. Moreover, policy could not prevent that many seasonal workers in the hospitality and broader tourism sector were not hired. While some employment losses have been recovered, by the **end of August employment was still about 3.2% smaller than at the same time last year**. Q2 data shows that especially workers on a temporary contract have borne the brunt, with temporary contracts down 21%. On top of that, **over 735.000 workers (4% of total workers) are in the short-time work scheme ERTE**. This means their employer has no work for them, but they are not fired either, with the government paying 70% of their salary. The government thinks –or hopes– that they will return on the payroll of their employer at some point. This seems to have happened to a large share of previous beneficiaries, as the number of people on a ERTE has substantially fallen from 3.4 million at the peak in April. Yet, we think part of the final ERTE receivers will eventually lose their job. It will take years before hard-hit sectors will have recovered their very large losses and hence before employment in these sectors can return to pre-crisis levels. Given the [very high costs](#) (2.5% of GDP so far) and difficulty in reaching the recent agreement on its extension until 31 January, it is unlikely the government will continue to extend ERTE until all ‘ERTE jobs’ are recovered. If the latter happens at all.

Employment in the construction sector never returned to pre-crisis levels after the housing market bust in 2008. Ideally the unemployed could find work in another sector, where they even are more productive. But that transition is easier made in economics text books than in the real world, especially given Spain’s rather weak scores on for example vocational training – a weakness the government would be wise to address. In any case it is likely to take years.

For preserving economic activity and employment, not only direct job support measures matter, but also liquidity measures that prevent firms from going bankrupt. [The uptake for government guaranteed loans has been significant](#). This helps to explain why **despite massive income losses by non-financial firms in the first half of the year, far fewer firms went bankrupt than in the same period last year** (figure 6). While from a macroeconomic point of view liquidity support is justified to help solvent yet temporarily liquidity constrained firms, current data suggests insolvent firms are also being rescued at the expense of the health of the public balance sheet and longer-term economic growth. In any case, once the support measures come to an end and matured guaranteed loans cannot be rolled-over, a wave of bankruptcies should be expected.

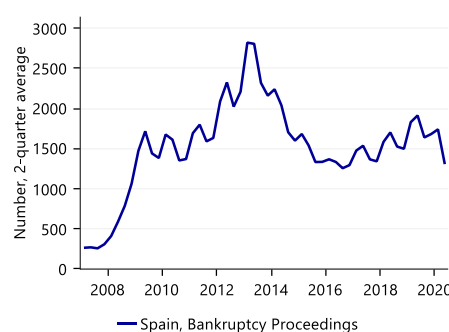
What this means for the unemployment rate (15.8% in June) is not clear cut. Clearly timing of the above is of essence, but it also depends on the number of people actively looking for a job: you are not counted as unemployed if you are not looking for a job. The number of job seekers has dropped dramatically during the crisis, putting a lid on the rise in the official unemployment rate. Taking all the above factors into account **we expect the official unemployment rate to average 15.7% this year and 20% next year**, compared to 14.1% in 2019 and the peak of 26.1% in 2013.

Figure 5: March saw largest drop in employment



Source: Macrobond, RaboResearch

Figure 6: Bankruptcy proceedings drop in 20H1



Source: Macrobond, RaboResearch

The Netherlands

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On September 15 the Dutch government presented its budget for the coming year. The Rutte-III government expects public debt to rise from 49% in 2019 to no less than 61% in 2021. We already saw debt to GDP reach 55.2% in the second quarter of this year. Both the expected and the realised debt to GDP increase have of course everything to do with the corona crisis.

Measures taken to guide the economy through the pandemic amount to EUR 62.5bn. This includes direct support like the compensation of labour costs through the job retention scheme ('NOW') and fiscal measures like tax deferral and VAT-exemptions on masks and other medical aid products for companies. These extra corona-related expenses are one of the reasons why the government expects its balance to tip over to a deficit of 7.2% (of GDP) in 2020 and 5.5% in 2021. A part of these corona related expenses were already done in the first half of this year.

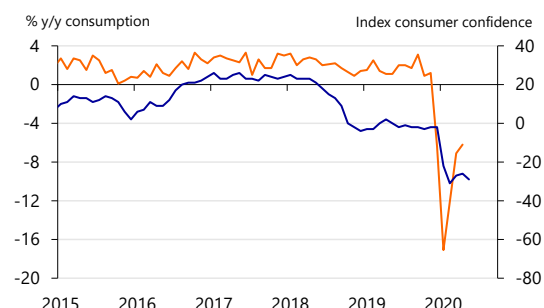
Extra government expenditures on Budget Day

In addition to the third support package, the government plans to implement other measures that might boost the recovery of domestic demand. These include a reduction of the tax rate applicable to the lowest income tax bracket, the increase in the employment tax credit was brought forward from 2022 to 2021, and the low level of the corporate tax rate will be decreased.

We already see the recovery of consumption slowing down and consumer confidence remains at a low level (figure 1). In July consumption rose slightly with 2% m/m, compared to the 8% and 4% increases seen in May and June. We do not expect consumption to bounce back to 2019 levels any time soon. As the infection rate is rising again, the government announced new restrictions at country level, in addition to some earlier local and sectoral restrictions. For instance restaurants and bars have to close at an earlier time, automatically leading to lower spending. These will last for at least the next three weeks. If the infection rate continues to increase, more restrictions might be in the cards. And in addition to the new restrictions, consumers may also avoid certain places, such as restaurants and shopping centers, to prevent catching or spreading the virus. For the former, the coming winter season additionally means lower capacity as people will not dine outside anymore.

Adding to that, the unemployment rate increased to 4.6% in August (figure 2). With the third support package being less generous than its predecessors and the number of infections increasing, we expect the unemployment rate to rise further to 6.6% in 2021, putting extra downward pressure on consumption.

Figure 3: Slow recovery of consumption



Source: Statistics Netherlands

Figure 4: Rising unemployment



Source: Statistics Netherlands

Even though the Dutch economy finds itself in the midst of a crisis, house prices continued to increase in August with 8.2% y/y. This reflects the low interest rate environment and the shortage of houses. On Budget Day, the government announced that it will step up its efforts to keep construction of new houses at a steady pace. They made an extra EUR 295 million available to remove bottlenecks for housing construction, for example. Additionally, the government abolished the 2% stamp duty for first-time buyers. A kind gesture, but we think that it will only

increase demand and therefore lead to more upward price pressure. On the other hand, the stamp duty on buy-to-let-properties will be hiked, which could lead to lower demand from investors. While house prices continued to increase in August, we do expect a correction in house prices in 2021 (figure 3), as an expected rise in unemployment will probably hurt demand for owner-occupied homes.

Figure 5: House price correction ahead

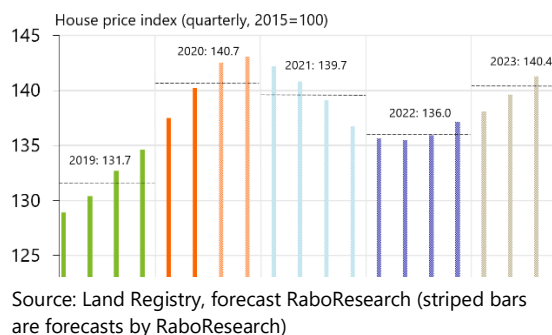
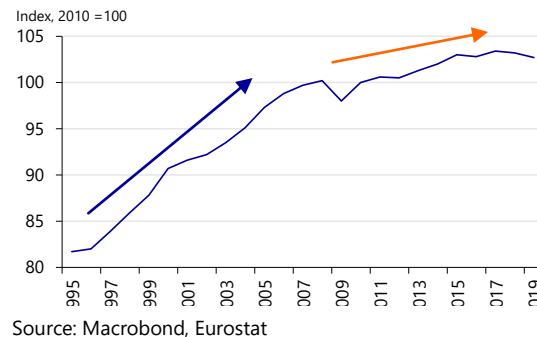


Figure 6: Stagnating productivity growth



Future growth

Besides plans to tackle the current economic issues, the government also thought about economic growth in the future. In order to ensure long-term economic growth, a National Growth Fund has been established. The aim is to allocate EUR 20bn in the next five years to knowledge development, innovation and infrastructure. Projects are eligible as long as they contribute to future Dutch growth and fall within these domains. Investments in productivity growth are welcome, as it has been falling back in recent years (figure 4).

Table 1: Economic forecasts

	2019	2020	2021	Q1/20	Q2/20	Q3/20	Q4/20
GDP	1.7	-5.2	2.1	-1.5	-8.5	4.3	0.6
Priv. consumption	1.5	-6.0	3.3	-2.6	-11.3	8.0	0.0
Govt. consumption	1.6	-0.7	3.9	-1.5	-3.1	5.0	0.5
Bus. investment	5.4	-6.8	3.2	-2.1	-13.0	7.5	0.0
Res. investment	1.6	-1.3	2.8	8.6	-9.9	5.0	0.0
Exports	2.7	-4.2	5.7	-1.9	-10.3	6.3	3.1
Imports	3.2	-2.6	7.4	-2.0	-9.5	8.0	2.9
HICP (% YoY)	2.7	1.3	1.1				
Unemployment rate	3.4	4.3	6.6				

Source: Rabobank

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Is there light at the end of the tunnel?

The latest slew of news articles points towards the possibility of a 'skinny' Brexit trade deal ultimately being concluded, in spite of the very loud noises surrounding the trust- and international law-breaking *Internal Market Bill*. In fact, over the past couple of days there have been several high-profile news reports that suggest that both Westminster and Brussels may be willing to take the talks into the 'tunnel'. A 'tunnel' is diplomatic jargon for intensified negotiations in combination with a media blackout. Other involved parties, such as backbench MPs, are then kept in the dark, and this should make it a bit easier to explore the various different routes that could ultimately lead to a deal. If the negotiators indeed do decide that it's worthwhile to start digging, which is likely to require reassurances on state aid, fisheries and governance first, it would be an unexpectedly positive outcome of this week's ninth negotiating round.

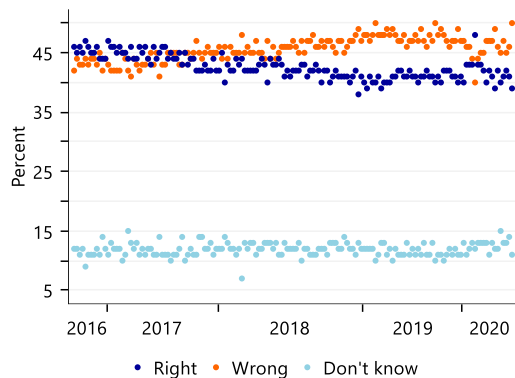
Even as the pendulum is swinging a little more towards a skinny deal, it remains a very realistic possibility that the talks collapse and that a deal will eventually be out of reach. This would mean that firms will have to trade under the WTO's non-preferential rules from January 1 onwards, which includes tariffs that in some sectors potentially exceed the margins of traders. Regulations are then also expected to gradually diverge, weakening the case for cross-border supply chains and trade even further. The economic damage would be substantial and it remains hard to see how this government can compensate for this by hoping to pick winners in emerging industries.

It is clear that a deal produces better economics than no deal, in particular amid a second wave of the virus, but it is far less certain that a deal also produces better politics. Surely, Boris Johnson is desperate for some successes, especially as Labour recorded its [first poll lead](#) since he became prime minister, but a deal that solely rests on significant concessions from the UK side is difficult to brand as such. He needs to have some (made-up) wins to point to as well: see for instance the [resolution](#) of the '[imminent food blockades](#)'. The only thing that really has been consistent throughout the Brexit-saga is that the so-called optics of a deal are as important as the content of said deal. This implies that there will be lots and lots of political drama still, most likely around the mid-October EU Council Summit, as Johnson needs to be seen to have put up a serious fight against Brussels. Whether a deal is eventually struck or not, he needs to be perceived as the ultimate defender of the country's interests in its pursuit of regaining sovereignty. In case of a deal, he can show that he's a dealmaker. In case of no deal, he can blame the EU's intransigence.

Eat out did not help out

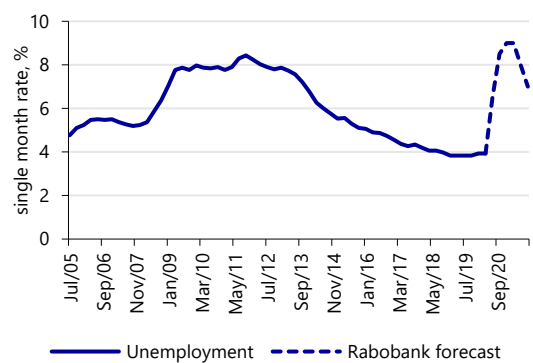
The government remains in pandemic crisis mode and the recent tightening of restrictions –e.g. the early closure of pubs and restaurants– is increasingly seen as a prelude to much more painful economic restrictions in coming weeks. Cases are rising at a rapid pace, as elsewhere in Europe, but the rise in transmission is also being associated with the naively optimistic "*Eat Out to Help Out*"-scheme and the official encouragements to go 'back to work'. The dynamics are now clearly heading in the wrong direction, and the UK has a long and dark winter to look ahead to. This has prompted Chancellor Sunak to scrap the autumn Budget and to revert to firefighting measures, even though he himself admitted that his winter jobs plan –a combination of wage top-ups, cash flow support for companies and extended VAT cuts for the hardest-hit sectors– isn't likely to prevent business failures and job losses over the coming months. The new Job Support Scheme will only support otherwise highly 'viable' jobs, and the cost of the package is expected to be a fraction of the near GBP 40bn spent on the CJRS furlough scheme so far. This all suggests once more that a V-shaped recovery remains elusive – regardless of the steep recovery in retail sales (+4.3% y/y in August) or the still elevated PMIs (55.7 in September). Yes, third quarter GDP growth will be one for the history books, but our outlook for Q4 this year (+1.3% q/q) and Q1 next year (+0.2% q/q) is based on the premise that this summer's recovery will slow down rapidly.

Figure 1: In hindsight, do you think Britain was right or wrong to leave the EU?



Source: Macrobond

Figure 2: ... yet unemployment is still set to rise in the autumn and winter



Source: Macrobond

Winter is coming

Against such a highly unusual economic and political backdrop, the Bank of England has the unenviable task of setting monetary policy. With rates at the effective lower bound, the MPC is adjusting its policy stance mostly through asset purchases. The APF was increased by GBP 100bn in early-summer, while the pace of weekly purchases has been decelerated. This allows the Bank of England to remain present in the gilt market until year-end. However, it's clear that the economy is in continued need of stimulus in 2021. **To avoid raising any doubts regarding the Bank's continued commitment to support the UK economic outlook, we would expect to see another GBP 100bn top-up to be announced at the November meeting.**

Even though the MPC went at great lengths to highlight the potential drawbacks of negative interest rates in the August *Monetary Policy Report*, centering their arguments on the risks to the banking system, Governor Bailey still insisted that such a policy remains in the Bank's 'tool box' for later use. According to him, the cost-benefit analysis of negative rates looks much better once the economy is in an upswing. While that's true, it's also a bit of a silly argument, really, to cut rates when things take a turn for the better. **We believe that these 'threats' are mostly made to underline the potential symmetry of the Bank's rate outlook, but remain reluctant to forecast negative money market rates. Asset purchases remain the MPC's policy tool of choice instead.**

Table 1: Economic forecasts

	2019	2020	2021	Q1/20	Q2/20	Q3/20	Q4/20
GDP	1.5	-10.5	4.4	-2.5	-19.8	15.8	1.3
Consumption	1.0	-11.9	4.6	-3.0	-23.6	21.0	-0.3
Investment	0.8	-15.6	-2.5	-0.3	-26.5	23.0	0.3
Government	3.5	-0.4	3.1	-4.1	-14.6	5.0	5.0
Export	5.0	-10.2	6.2	-10.7	-11.0	15.0	0.5
Import	4.7	-18.6	6.7	-9.2	-22.7	23.5	0.8
CPI (%y-o-y)	1.8	0.9	1.4	0.7	0.5	0.7	0.7
Unemployment rate	3.8	5.7	8.3	3.9	6.5	8.5	8.5

Source: Rabobank

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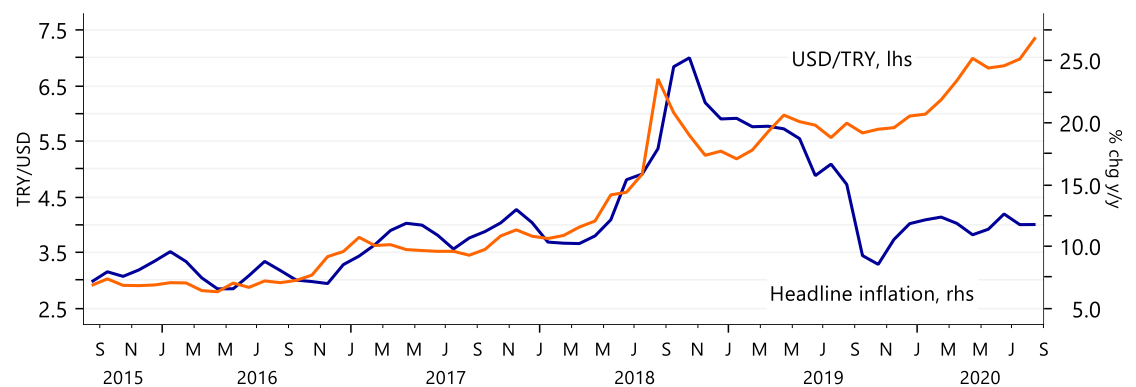
A proper rate hike, but is it enough?

As his predecessor Cetinkaya in 2018 (and before him Basci in 2014) Governor Uysal finally responded in a proper way to the precipitous fall in the value of the Turkish lira when he raised the benchmark 1-week repo rate by 200bp to 10.25% on September 24.

The CBRT made a very important step in the right direction. The 200bp move reduced the risk to inflation and financial stability. The decision also validated our long-held view that the strategy of spending tens of billions of dollars trying to slow down the pace of the lira's depreciation is not sustainable, as Turkey is rapidly running out of precious FX reserves.

However, this is just the beginning of a potentially long-term process to restore the shattered confidence in the lira – not only amongst foreign investors, but also amongst domestic households and corporates.

Figure 1: Do not let the wide gap mislead you – the sharp rise in USD/TRY is still inflationary



Source: Macrobond

Due to its persistent inability to meet the official 5% inflation target over the years, the CBRT does not have high credibility amongst market participants. This is one of the reasons why the lira plunged precipitously after the central bank slashed interest rates aggressively from 24% to 8.25%. The market was not convinced that inflation will align with the 5% target over the monetary policy horizon of around two years. And the recent 200bp hike is unlikely to increase the market participants' confidence enough to declare that the lira is out of the woods. After adjusting for inflation, Turkey's real interest rates are still in negative territory. With inflation on track to end this year above 10%, the CBRT will have to seriously consider more hikes in the coming months to make the lira attractive for carry trade players who look for opportunities across emerging markets.

This brings us to another important element of monetary policy: *how much room for manoeuvre does the CBRT have to raise rates before political pressure on Governor Uysal increases substantially?* After all, politicians prefer accommodative monetary policy to stimulate growth and this not only applies to Turkey, but to the vast majority of developed and developing countries.

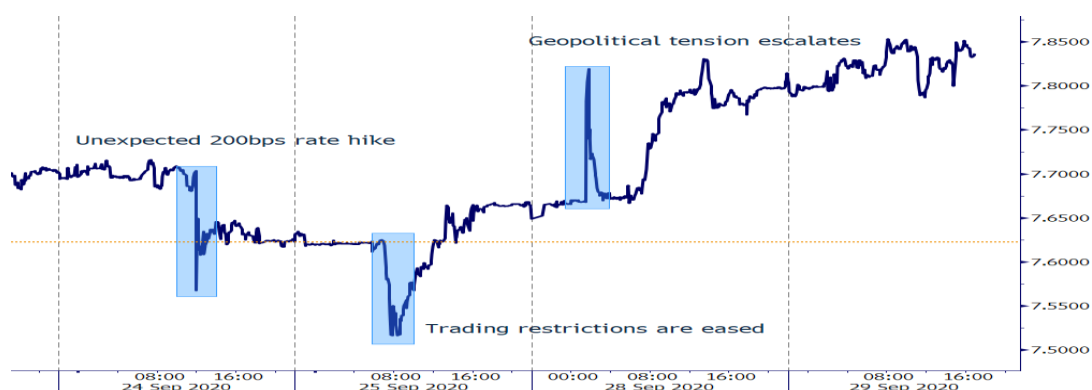
It is very difficult to tell how much leeway the government will give the CBRT as prominent Turkish officials refrained from officially commenting on the 200bp hike. While markets in general prefer politicians not to comment on monetary policy, in case of Turkey investors would probably like to hear from the Erdogan administration as it would allow them to assess the CBRT's ability to raise rates by another few hundred basis points to ensure prolonged stability of the lira. With three more meetings left this year, we expect another 200bps hike in October. This should be followed by at least one more 200bps move if the CBRT intends to stabilize the currency and bring inflation under control.

We remain of the view that the balance should shift in favour of aligning inflation with the 5% target rather than allowing the lira to depreciate even further in anticipation that it will lure international corporates to shift their production away from Asia to somewhere closer to Europe. Turkey definitely does not need an even weaker currency to gain competitive advantage. There is a fine balance between a competitive and an unstable currency. The former offers a major advantage when the objective is to increase country's share in global trade (assuming that inflation is relatively low and the central bank has high credibility) while the latter can be a deterrent. In our view the lira has moved too far into the group of unstable currencies.

Geopolitical risk escalates

The relief provided by the unexpected 200bp hike proved short-lived when geopolitical risk escalated markedly. Fierce clashes between Armenian and Azerbaijan forces along the contact line of the long-disputed territory of Nagorno-Karabakh reignited the upside pressure on USD/TRY, which set yet another record high above 7.85.

Figure 2: The last few sessions have been very volatile for USD/TRY



Source: Macrobond, Rabobank

There are concerns that Russia and Turkey could be dragged into the conflict supporting opposite sides. The former is seen as a traditional ally of Armenia, while Turkey has close ties with Azerbaijan. And although previous clashes between Armenia and Azerbaijan lasted just a few days, the current fighting seems to be the most serious yet in a conflict that started after the Soviet Union collapsed more than three decades ago.

The lira will remain vulnerable until both sides of the conflict express willingness to start negotiating a ceasefire. Remarks from Azerbaijani President Aliyev and Armenian PM Pashinyan imply that they have no intentions to seek mediation at this very early stage of the conflict which seems to be intensifying. The Defense Ministry in Baku reportedly accused Armenia of shelling Azerbaijani territory across their border and pledged to retaliate. The longer it takes Turkey, Russia and Western powers to convince Azerbaijan and Armenia to stop fighting, the higher the risk that USD/TRY could reach yet another unprecedented level of 8.00 in the short-term.

Apart from watching further developments in the Caucasus Mountains, talks between Greece and Turkey regarding territorial claims in the eastern Mediterranean will set the tone for the lira. The risk that the EU may impose sanctions on Turkey has fallen after Greece and Turkey agreed to resume talks. However, one should not be complacent that dispute over maritime claims may escalate further.

Last, but not least, the outcome of the US presidential elections will have an impact on the lira as well. President Trump has refrained from imposing sanctions on Turkey for purchasing the Russian S-400 defence system. Therefore, if he is not re-elected on November 3, the issue of S-400s may once again weigh on the lira.

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Red mirage and blue shift

Early voting in the 2020 elections has already started, but the results will remain unknown at least until Election Night (November 3). In fact, it could take several days or weeks before we know the outcome. The election results may come in slowly, and they are likely to be contested anyway. While fair elections are crucial to any democracy, in the US both main political parties show little trust in the elections. Republicans often claim that voter fraud takes place which should be prevented by restrictions to voting. In turn, Democrats assert that these measures are aimed at voter suppression. The problem is that unlike other major democracies, the US electoral process is not organized by a neutral body. What's more, people are not automatically registered as voters. In fact, the US has a long history of voter suppression that goes back to the nineteenth century when Southern states started to suppress black voters after the Fifteenth Amendment guaranteed their right to vote in 1870. And this was voter suppression by the Democratic Party by the way. What's more, the legal door to more voter suppression today has been opened by the expiration of the 1982 'consent decree' that prevented the Republican Party from engaging in activities that suppress the vote, particularly when it comes to minority voters. This year the Republicans are recruiting 50,000 volunteers in 15 contested states to monitor polling places and challenge voters they deem suspicious-looking. This would be nothing new: the reason for the consent decree was the intimidation of minority voters by the Republican 'National Ballot Security Task Force', which consisted of off-duty law enforcement officers, in the 1981 New Jersey gubernatorial election.

President Trump's assault on voting by mail may also be seen in light of voter suppression. Perhaps because he thinks that Democrats are more likely to use this method more frequently than Republicans given their [higher concerns about Covid-19](#). But more importantly he is trying to get his voters to go to the polls instead of mailing in their votes and give him an early lead when voting results are announced. This then would put him in a stronger position to claim fraud when the results from the mail-in ballots are announced and give Biden a late boost. Voter suppression is more effective if you know in which pocket you can find more voters of the other party and fewer of your own party. This time it will be in the mail. Therefore we are likely to see a pattern in the election results as they are announced over time. A 'red mirage' may give Trump an early lead on Election Night, but a 'blue shift' will slowly benefit Biden in the overtime count. While Trump has already announced he will not concede, Biden is likely to wait out the blue shift. In other words, an early concession seems unlikely. In fact, we may not see any concession at all. Instead, the loser is likely to contest the results.

While there are few actual convictions of voter fraud, there are numerous cases of incompetence in the electoral process. Of course, this is damaging to the credibility of the elections. Since this incompetence tends to occur in large cities, run by Democrats, this fuels the Republican claims of voter fraud. Meanwhile, the mutual distrust between Republicans and Democrats are fuelled by America's enemies. Most notably, there is substantial evidence that the Russians are stoking the fire through social media, sometimes amplified by the mainstream media. Finally, the rhetoric from both parties about the elections does little to boost confidence in their fairness. President Trump has already decided that the 2020 elections are rigged and he will not accept defeat. Meanwhile, the Democrats are spurring their voters to produce an overwhelming majority to prevent all kinds of nightmare scenarios. How much trust in the fairness of the election outcome are voters supposed to have if this is what the two main political parties are telling them?

Turbulence ahead

While the US economy is in a mechanical rebound from the lockdown, [several headwinds are converging to pose a threat to the recovery in Q4](#). The pace of the recovery is already slowing as households and businesses are struggling with the impact of the lockdown and the virus. Although it seems that the first wave of the coronavirus in the US has peaked, the level of infections remains elevated. This has raised the risk of a second wave in Q4. Meanwhile, the extension of the fiscal stimulus has yet to arrive, is late, and is likely to be modest. At least a government shutdown on October 1 has been avoided after President Trump signed a stopgap bill into law that will keep the federal government funded through December 11. Unfortunately, this means that we could still be looking at a government shutdown by December 12. In addition, the US elections are likely to lead to increased tensions with China, as opinions about China have become negative among both Republicans and Democrats. Finally, as discussed above, the US election results are expected to come in slowly in November and are likely to be contested. This will only amplify [the ongoing civil unrest](#). Although some headwinds may turn out less severe than others, the US recovery is up for a serious test in Q4 which could cause a temporary setback (see Table 1). The headwinds are likely to cause considerable market turbulence in Q4.

This also means that the FOMC could meet in a storm on November 4-5. [At the September meeting](#) the Committee adjusted its forward guidance on rates to reflect the new monetary policy strategy of flexible average inflation targeting. This was supported by updated and extended rate projections that see the target range for the federal funds rate at the zero bound through the end of 2023. However, a significant setback in the economic recovery would force the Fed to rethink its monetary policy stance. This could even push the Fed beyond forward guidance. [Given the Fed's aversion to negative rates](#), the next logical step would be [yield curve control](#).

Table 1: Economic forecasts

	2019	2020	2021	Q1/20	Q2/20	Q3/20	Q4/20
GDP	2.3	-6.2	1.3	-5.0	-31.7	12.6	-0.8
Consumption	2.6	-6.7	1.5	-6.9	-34.1	15.0	0.5
Business inv.	2.0	-7.4	3.2	-6.7	-26.0	10.0	-5.0
Residential inv.	-1.5	-1.4	2.6	19.0	-37.9	15.0	-5.0
Government	2.3	2.1	1.7	1.3	2.8	2.5	1.6
Trade	-0.2	0.3	-0.3	1.1	0.9	-0.2	-0.6
Inventories	0.2	-1.7	0.0	-1.3	-3.5	0.8	0.1
CPI (% YoY)	1.8	0.7	1.6				
Unemployment rate	3.7	10.0	8.5				

Note: * Contribution in pp. Source: Rabobank

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Monetary out...

The Bank of Canada left its policy rate on hold at 0.25% on September 9 as was widely expected by both analysts and traders alike. The Bank also left the current minimum pace of bond purchases at CAD 5bn per week. The BoC highlighted the slightly faster recovery in the US and the strong rebound phase observed as the Canadian economy reopens, but this was dampened by the cautious tone around continued Covid risks: *"While recent data during the reopening phase is encouraging, the Bank continues to expect the recuperation phase to be slow and choppy as the economy copes with ongoing uncertainty and structural challenges. The pace of the recovery remains highly dependent on the path of the COVID-19 pandemic and the evolution of social distancing measures required to contain its spread."* In terms of inflation, the Bank highlighted the lack thereof *"reflecting a large degree of economic slack."* The Bank went on to suggest that rates will remain unchanged until that slack is absorbed and the 2% inflation target is *"sustainably achieved"*. And in terms of asset purchases, *"this QE program will continue until the recovery is well underway and will be calibrated to provide the monetary policy stimulus needed to support the recovery and achieve the inflation objective."*

Table 1: Rabobank economic forecasts

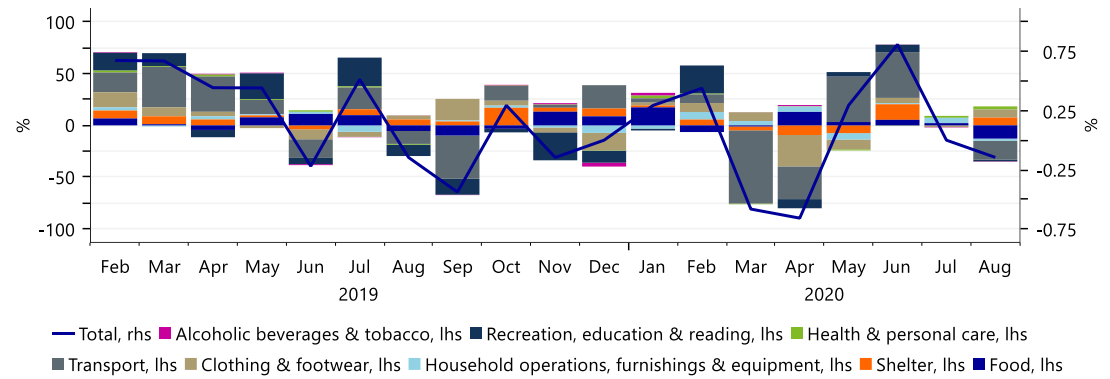
	2020	2021	2022	2023	2024	2025
GDP	-6.7	4.0	2.5	1.8	1.9	1.9
Private consumption	-7.5	4.5	2.6	1.4	1.6	1.6
Business investments	-9.5	7.0	1.4	0.9	1.0	1.0
Housing investments	-6.0	5.5	2.5	1.5	1.6	1.6
Government consumption	0.0	3.0	1.6	1.3	1.5	1.5
Government investments	0.5	2.5	1.6	1.7	1.5	1.5
Export volume	-10.4	7.0	4.2	3.0	3.0	3.0
Import volume	-13.0	7.0	3.4	1.7	1.8	1.8
Inflation (%)	0.6	1.5	2.2	2.0	2.0	2.0
Unemployment (%)	9.0	6.0	5.8	6.1	5.8	5.6

Source: Rabobank

A look at CPI inflation and the likely path going forward support our view that if anything, we may see the BoC ease further. But given our strong view that the Bank will not dip into negative policy rates, further easing would most likely emerge through increased asset purchases. We do still expect the Bank to increase its weekly minimum purchases to CAD 10bn but the Bank seems in no rush at the moment. Headline inflation disappointed market expectations at just 0.1% y/y in August while the common core measure printed at 1.5%. We expect the output gap to remain wide and demand driven pressures are likely to remain distinctly absent this year and into early next year. In fact, we don't see CPI inflation returning to target until 2022.

Although we noted our expectation that the BoC will end up increasing asset purchases down the line, really the onus has shifted from monetary policy to fiscal policy – a theme we are of course seeing globally as central bank policy fails to provide support to real world activity. As we have highlighted for the past eight years and as has been clearly evident in the microcosm of recent months, easy monetary policy helps the financial system but is limited in its positive impact on real world activity while helping exacerbate structural problems that plague economies for years.

Figure 1: Canadian CPI inflation m/m



Source: Macrobond

...fiscal in

Prime Minister Trudeau used the Throne Speech to find his “Inner Draghi” as he channeled the ex-President of the ECB, Mario Draghi, and uttered the famous promise to do “*whatever it takes*”. Indeed, Trudeau put the Liberal federal government on the line in doing so as the minority government needs support from other parties to push through the fiscal stimulus. Unsurprisingly, the Conservatives did not jump on board, but at the time of writing it is expected that the NDP will lend support to ensure the package goes through (our base case). However, if the vote fails then an election will be triggered. Trudeau outlined his “*ambitious plan for an unprecedented reality*” as Covid-19 cases rise again. The government outlined plans to increase testing across the provinces and vowed to create one million jobs while extending and increasing benefits for those still out of work through next summer. Trudeau also spoke of plans to help industries hit particularly hard by Covid-19 such as tourism and hospitality sectors.

Reversing the move

On these pages in August we noted that CAD was being used as a funding currency for participants looking to reduce the sensitivity to risk of carry trade positions. We discuss this in more detail in the Mexico section of this publication (p. 27) but in short, in the summer there were signs of flows going through the CAD/MXN cross. In 2019 and early 2020, MXN was a popular carry currency (and remains the most attractive globally when adjusting for volatility and liquidity) but rather than using EUR as a funding currency, as we saw last year, carry trade players turned to CAD after the BoC cut rates to 0.25% and the broad-based bid for risk spread to the FX market. The reason for this is that as somewhat of a risk proxy currency within the G10 space, CAD/MXN is far less sensitive to shifts in risk sentiment than EUR/MXN or USD/MXN for that matter. Given that risk-on was the dominant theme through summer but the clouds of risk loomed large, taking this approach was logical even if the reduction in market beta achieved from funding in CAD meant given up some carry returns compared to EUR. Recent price action saw CAD/MXN surge 6% across just four sessions and to our mind this reflected the unwind of the summer carry trade. Looking ahead, we expect USD to find support heading into the US presidential election and the weeks following which means we expect USD/CAD to primarily trade with a 1.34 in Q4 with a move towards 1.35 as we head into year end.

Mexico

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More to come

Banxico cut the policy rate 25bp to 4.25% at the September 24 meeting, in line with most analysts' expectations and implied market pricing. The decision was unanimous and the statement noted that room for maneuver is "narrow". Heading into the meeting the market implied around a 20% chance of another 25bp cut and the tone of the statement certainly suggested that the easing cycle has either ended or will end soon. In our preview, we shifted our call to a 25bp cut –having previously expected a 50bp cut before the Minutes of the prior meeting were released– but we maintained the view that the policy rate will be cut below 4%. We maintain that view despite it standing in contrast to the implications of the statements following the latest meeting. The Bank focused on the recent rise in CPI inflation, which does of course tie the Bank's hands somewhat given the 4.10% print seen in the first half of September.

On the topic of inflation, the Bank noted that there are considerable risks in the short and medium term:

"To the downside:

- i) a greater than expected impact of the widening of the negative output gap;*
- ii) downward inflationary pressures worldwide; and*
- iii) social distancing measures reducing the demand for certain services.*

To the upside:

- i) additional episodes of foreign exchange depreciation;*
- ii) a high persistence of core inflation; and*
- iii) logistical problems and higher costs associated with the sanitary measures.*

The balance of risks for the projected trajectory of inflation remains uncertain."

While we certainly sympathise with the difficulty in having high conviction over the likely path of inflation data, or indeed, any economic data, given the exceptional backdrop facing Mexico and the rest of the world, we think CPI inflation is likely to be topping out this month and see the balance of risks as skewed to the downside heading into 2021. To our mind, the output gap is key here and our estimates have it wider than the Bank is currently stating. Plus, we see significant risk that a slower demand rebound will only serve to exacerbate the output gap further, thereby alleviating pressure on prices in Q4 and into Q1.

In light of this view on inflation, we see the door as still open with room to ease and we expect the terminal rate will have a 3 handle rather than a 4 in front. We agree with the potential positive price impact of MXN depreciation, which we expect to see more of. However, we see little risk of MXN depreciating because of additional rate cuts given the relative attractiveness of Mexican rates compared to the rest of the LatAm region and much of the broader emerging market space. Indeed, we maintain the view that rates could be cut down to 3.50% and MXN would still be the most attractive carry currency globally when adjusting for volatility and liquidity. Furthermore, the departure of Javier Guzman next year leaves a more dovish tilt and we expect that will only be furthered by the choice of his replacement.

In summary, heading into the meeting the front-end of the MXN rates curve implied a 25bp cut in September and around a 20% probability of another 25bp cut. Of course, the 25bp cut was forthcoming and an assessment of the statement could imply that around a 20% chance of another 25bp seems reasonable. That said, we see the balance of risks to inflation as less symmetrical and far more skewed to the downside with CPI inflation likely to slow below 4% in Q4

and return to 3% in early 2021. As such, we maintain the view that the policy rate will be cut below 4% in Q1 of next year and our expected terminal rate remains unchanged at 3.50%

Table 1: Rabobank economic forecasts

y/y (%)	2020	2021	2022	2023	2024	2025
GDP	-10.5	4.9	3.4	2.8	2.8	2.8
Domestic demand	-11.9	5.2	4.3	2.8	2.8	2.8
Export volume	-9.0	6.5	3.5	2.7	2.6	2.6
Import volume	-13.0	7.5	5.9	2.7	2.6	2.6
Inflation (%)	3.5	3.0	2.7	2.6	2.6	2.6

Source: Rabobank

North American carry

Regular readers will be more than aware of the importance of the carry trade for MXN. It was carry that led MXN to be one of the best performing currencies of 2019 despite the Mexican economy being one of the worst performers as the manufacturing recession in the US weighed heavily on Mexican activity. As we have highlighted on these pages countless times, the general mantra for trading Mexico over the past few years has been “stay long MXN and collect the carry but protect yourself against a volatility driven drop”. We wrote those words, or some variation of, so many times that it became like a broken record.

In 2019 and early 2020, it was EUR/MXN that dominated the carry flow but this summer we noted on these pages that the tentative tip toeing into the carry trade seemed to be playing out via the CAD/MXN cross. Intuitively that made sense. The risk bid began in high yield bonds and equities after the Fed’s asset purchase announcement in March but this eventually spread to FX and commodities. That said, this risk bid was against the backdrop of the largest supply and demand shock to hit global economies in living memory and while strong arguments could be made as to why the bid for risk would continue, it is fair to say that there was, and remains, a lingering cloud of potential shocks that could drive volatility higher and trigger sharp outflows from risk proxy currencies. As a result, those looking to enter carry trades sought a way of eliminating some of that market beta by looking for crosses that weren’t so closely driven by “risk-on, risk-off”. In light of the slashing of interest rates by the Bank of Canada to 0.25%, although still more expensive than funding in EUR, CAD trades as somewhat of a risk proxy within the G10 space so this became a more attractive option given the more muted relationship CAD/MXN has to broad-based shifts in risk sentiment. We wrote about this back in August and although it was difficult to prove this quantitatively, anecdotal evidence supported that call. Since then, the drop in risk appetite in late September was accompanied by a 6% surge in CAD/MXN over just four sessions which to our mind supports the view that this trade was helping to support MXN over the summer. Looking ahead, we expect volatility to remain elevated as we head into the election and in the weeks after. As a result, we expect USD/MXN to push above 23 heading in Q4.

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Covid-19: turning a corner

On 29 September, Brazil reported a total of 4,777,522 Covid-19 cases and 142,921 fatalities (from 3,908,272 cases and 121,381 fatalities on 31 August). Brazil has lost the second global ranking in total cases to India, but in terms of fatalities it still places second. More importantly, together with many countries in Latin America (excluding Argentina), Brazil's seven-day rolling average of daily infections keeps trending down (26,560; 31 Aug: 40,773). The same metric for daily fatalities (currently at 688; 31 Aug: 867) has receded to mid-May levels from 25 July's high of 1,097 per day. According to PUC-Rio academics, Covid's effective reproduction number (R_t) for the whole country has fallen from 1.01 on 1 September to 0.92 on 27 September. Finally, since June, the country has been the testing ground for four potential vaccines (by AstraZeneca/University of Oxford, Sinovac, Johnson & Johnson, and BioNTech/Pfizer/Fosun), while three more (by Sinopharm, Gamelaya and United Biomedical/Dasa) await the government's go ahead.

Real activity: Q3 better than expected

We expect GDP to fall by -5.9% in 2020 and to grow by 3.6% in the next year. The monthly GDP proxy calculated by the BCB posted a third positive gain in July, of 2.1% m/m after 5.3% in June. IBC-Br now stands -6.5% below pre-pandemic levels, and has thus recovered 55.5% of the March-April lockdown-led contraction. For Q3, July's number leaves a carry-over of 6.3% and for the whole of 2020, of -4.7%.

An uneven recovery is in place, with the service and retail sector trending apart. Rising by 7.2% m/m in July, broad retail sales are only 2% below their February level. On the production side, the recovery has been steady as well: July's industrial production grew by 8.0% and now lacks 6% to reach back to pre-pandemic amounts. The services sector, which has been severely hit by social distancing measures and clocks the slowest recovery in the reopening phase, grew only 2.6% m/m in the month. That still sees the sector 13% down from February. For the current quarter, we see GDP growing by 4.7% q/q (-7.5% y/y). However, the latest data have skewed the risks to our projection to the upside, which logically also adds a positive bias to our full-2020 GDP forecast.

Fiscal policy: it's even more complicated

The 2020 fiscal balance can only go south and debt can only go up. On one hand, a deteriorating economy causes revenues to collapse. On the other, expenditures are soaring due to the measures to fight Covid-19. In August, federal government tax revenues edged up by 1.0% y/y after -20.6% y/y in July. In the same month, the central government's total outlays rose again by 74.3% y/y (from 44.9%), pushing the primary deficit to about BRL 96.1bn. If we are right about our GDP forecasts, we see the consolidated public sector posting a primary balance of BRL -913.3bn, or -13.1% of GDP (2019: -0.9%); a nominal balance of -17.6% of GDP (2019: -6.9%); and net and gross debt-to-GDP ratios of 70.6% (2019: 55.7%) and 98.3% (2019: 75.8%).

How sustainable is that? The enactment of the so-called War (effort) budget on 7 May separates temporary Covid-19 outlays from permanent ones in 2020. But, further outlay pressures have to be contained and the spending cap must be allowed to remain a binding fiscal anchor. If the government manages to do so, the primary fiscal deficit will likely shrink to 3.3% of GDP in 2021 and the gross debt-to-GDP ratio will stabilise at high levels (about 99.2%). That said, the government has recently revived the creation of a permanent expenditure social programme called *Renda Cidadã*, funded with temporary sources of income (court-mandated payments) and redirected resources from the education fund Fundeb, which is not subject to the spending cap. If approved by Congress, the new programme would replace the corona voucher programme, which ends in 2020 and has supported consumption and arguably [Bolsonaro's popularity rating](#). Additionally, the government also faces pressure to raise infrastructure expenditures.

Inflation: one-off spikes should soon dissipate

Short-lived pressure on non-core items makes us see 2020 CPI inflation at 2.2% (from 1.7% before) and 3.2% by end-2021. September's mid-month inflation estimate rose to 0.45% m/m (Aug: 0.23%), and the year-on-year reading advanced to 2.7% y/y (from 2.3%), which falls within the BCB's 2020 target range (2.5-5.5%). Price pressures emerge mostly from volatile food items such as tomatoes (22.5% m/m), rice (9.96% m/m) and soy oil (20.33% m/m). Services actually slowed to 2.2% y/y (Aug: 2.4%). This reflects the lack of demand, as seen in the labour market: the July unemployment rate is expected to rise to 13.7% (Jun: 13.3%, Jul 19: 11.8%). We reckon unemployment could average 14.2% in 2020 (2019: 11.9%), leaving 2020/21 inflation depressed.

Monetary policy: forward guidance remains still amid fiscal risks

We still expect the Selic rate at 2.00% by the end of the year and at 3.00% by end-2021. The minutes of the 15-16 September meeting, when the Copom decided to hold the Selic rate at an all-time low of 2.00%, reinforced their latest forward guidance. That is, once the necessary conditions are met, the Committee would not only keep interest rates on hold, but they could even cut them. Although they acknowledged the rise in food prices and the costs of some services, the Copom judged all the necessary conditions in their guidance are satisfied: i) inflation expectations and the baseline inflation projections remain below the target in the relevant horizon; ii) the ongoing fiscal regime has not changed; and iii) long-term inflation expectations remain anchored. The minutes echoed the statement: eventual new cuts to the interest rate, if necessary at all, would demand more clarity on activity and inflation and could be spaced out, but we still think they will only move the Selic again in 2021Q4 (+100bps).

Foreign exchange: fiscal spill over

We revised our USD/BRL expectation to 5.35 (from 5.25) by end-2020 and 4.95 (from 4.90) by end-2021. Volatility resumed in the second half of the month. External factors included jitters over a second Covid-19 wave, a new US fiscal package adding to US elections volatility, and US-China tensions. Domestically, concerns remain around the government's fiscal stance in H2 and how they can accommodate pressures to boost expenditures, while the administration still has to advance on structural reforms. With a higher local demand, we now see imports at USD 151.4bn (previous: 147.6) in 2020, while more hesitant destinations other than China drive exports to USD 211.5bn (from 218.2). These forecasts would lead to a trade balance of USD 60.1bn (from 70.6), and a current account of +USD 2.1bn (from 13.1), benefiting from USD 43.9bn (from 59.6) in FDI.

Table 1: Economic forecasts

	2019	2020	2021	Q2/20	Q3/20	Q4/20	Q1/21
GDP	1.1	-5.9	3.6	-11.4	-7.5	-4.3	-2.4
Consumption	1.8	-5.4	3.5	-13.5	-7.4	-4.4	-3.1
Investment	2.3	-7.2	4.7	-15.2	-9.1	-4.8	-1.6
Government	-0.4	0.4	0.0	-8.6	0.4	0.2	0.5
Exports	-2.5	-2.8	3.0	0.5	0.3	0.0	0.2
Imports	1.1	-4.2	0.8	-14.9	-8.9	-4.5	-2.2
CPI (% YoY)	4.3	2.2	3.2	2.1	3.0	2.2	2.7
Selic rate (eop)	4.50	2.00	3.00	2.25	2.00	2.00	2.00
U.R. (avg)	11.9	14.2	15.5	13.3	15.2	16.1	16.7

Note: Quarterly figures are reported as y/y growth. Numbers in red are forecasts. Source: Rabobank, BCB, and IBGE.

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The sweet and sour of Suga's power

As widely expected, Yoshihide Suga was elected as Japan's new prime minister on September 16, comfortably winning with [70.5% of the 535](#) possible votes from government officials. Suga quickly moved to appoint his new cabinet. His cabinet appointments signal two things: policy continuity and conformity. Regarding the first, Suga has retained many of the ministers in Abe's cabinet, amongst which important posts such as those of finance minister (Taro Aso), foreign affairs (Toshimitsu Motegi) and economy minister (Yasutoshi Nishimura). Regarding the second, the choice of cabinet appointments is well balanced across the various factions (subgroups) within the ruling Liberal Democratic Party (LDP). So Suga seems intent on managing the various interests within the LDP, being a conformist rather than a fierce reformer.

Nonetheless, some reforms are definitely on Suga's mind. He has appointed a new minister responsible for digital policy. That is a welcome development, given that Japan has a relatively high reliance on 'old' technologies such as fax machines, the use of which is sometimes [implicitly required](#) by law. Reforms along this dimension are a quick win. Less of a quick win will be reforms to further increase female participation in the labour market or policies to further improve the corporate governance of listed firms. Whether Suga will achieve these reforms partially depends on his ability to stay in office long enough. This is anything but a certainty, especially with general elections coming up in October 2021.

On the foreign policy front, Suga has rapidly started talking with [Putin](#) and [Xi](#) on improving ties. We do not expect marked improvements in the ties with China though. Suga will be mindful not to alienate the China hawks within the LDP or alienate the US (with whom Japan has strong military ties). Both limit how far Japan can go in improving its relations with China. Moreover, Japan still has an ongoing border dispute with China regarding the Senkaku Islands.

Suga has repeatedly said that his focus right now is to fight Covid-19. Suga might want to back his promise with actions, possibly in the form of more fiscal stimulus. Given the already huge sizes of Japan's previous two stimulus packages, a possible third fiscal package will likely be smaller, and might include [further dipping](#) from an already existing JPY 10 trillion reserve fund to fight a second wave of coronavirus infections.

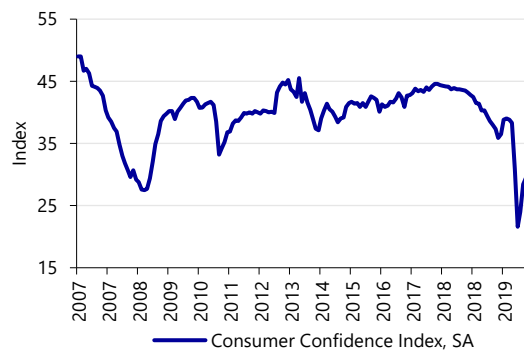
Economics: a bit better, but still bad

The macroeconomic picture continues to show weakness, which is understandable because coronavirus infections are still increasing in Japan, albeit at a slower pace. Rising infections lead to more voluntary social distancing and weaker consumer sentiment. The latter continues to be below levels seen during the Great Financial Crisis, despite an initial bounce back in June and July (figure 1). Retail sales have also not recovered fully. Although the August figure increased by 4.6% m/m, it is still down by 2% y/y. The same holds for industrial production, which marginally increased in August by 1.7% m/m, but was down 12% y/y.

Meanwhile, unemployment has continued to increase (to 2.9% in July) while the jobs-to-applicants ratio fell further (1.08 in July), both pointing to labor market weakness. That in turn, will weigh on consumer demand going forward. The external environment is not providing much relief either. Although Japan's exports in nominal terms rose 6% m/m in August, they are still down 12% y/y. In fact, exports have been consistently lower than last year since the beginning of this year (figure 2).

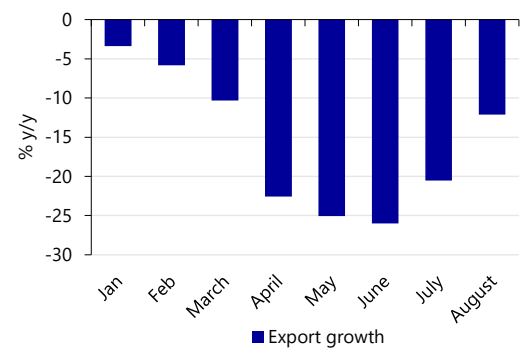
All in all, we think that the positive effect of a possible third round of fiscal stimulus could very well be countered by a weaker than expected recovery, which is why we stick to our belief that Japan's real GDP will decline by 4.9% this year.

Figure 1: Consumer sentiment is still very weak...



Source: Macrobond

Figure 2:...as is the external environment



Source: Macrobond

BoJ: a little more optimistic

The BoJ did not alter its monetary policy at its [meeting](#) on 16 and 17 September. The [Summary of Opinions](#) reveals that the BoJ was a bit more upbeat about Japan's economic prospects, mentioning that the economy "*already has bottomed out and is gradually recovering*". However, the BoJ recognized that the recovery is moving slower than during its previous meeting.

The Summary also shows that the BoJ is thinking about reviewing its policy approach, as its 2% inflation target seems increasingly far away. With regard to the Fed's decision to target average an average inflation rate, the BoJ said that it already targets an average inflation of 2% over the business cycle. With that statement, the BoJ seems to be signaling it will not change its monetary policy approach (at least in terms of inflation targeting) anytime soon.

We continue to think the BoJ will remain in wait and see mode for now. The BoJ already has a huge monetary stimulus package in place, of JPY 110 trillion (USD 1 trillion), and will likely await the new cabinet's plans before moving.

Meanwhile, Japan is –again– facing the risk of deflation. The BoJ's preferred measure for core inflation (which excludes fresh food, but includes energy) came in at -0.4% y/y in August. The BoJ expects this to improve as the economy recovers, although it still expects inflation to remain negative for the time being. We agree that with the latter, but are less optimistic about the former. Given Japan's rapidly ageing population and entrenched weak inflation expectations, we expect inflation to stay low for years to come.

Table 1: Economic forecasts

	2019	2020	2021	Q1/20	Q2/20	Q3/20	Q4/20
GDP	0.8	-4.9	2.9	-2.0	-10.0	-5.0	-2.5
Consumption	0.2	-6.1	2.2	-2.7	-11.1	-5.4	-3.0
Investment	1.1	-6.5	4.6	-4.0	-3.0	-10.0	-5.0
Government	1.9	1.9	3.0	2.5	0.9	2.0	2.0
Trade	-0.2	-1.0	0.3	-0.1	-2.5	-0.6	-0.6
Inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0
CPI (% YoY)	0.6	-0.7	1.0	0.5	0.1	-0.7	-0.7
Unemployment rate	2.4	4.0	3.5	2.4	2.8	4.0	4.0

Source: RaboResearch

The upside-down side

China's currency continues to hold up well despite the recent slip in several other EM FX crosses versus the USD. There are some ostensibly valid reasons for this. First, we are seeing more capital inflows from foreigners, and these are (perhaps) likely to pick up further in 2021 as Chinese sovereign bonds are included in the FT Russell bond index.

Of course, this overlooks the fact that China's FX reserves remain flat, which shows that for every dollar flowing in from foreigners, a dollar is flowing out from locals. This is bullish how?

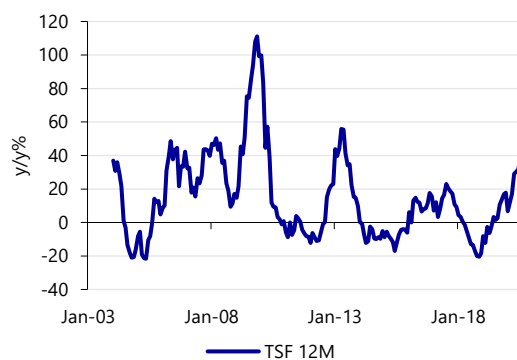
Likewise, Chinese data look reasonably good in a global context. Consider, for example, that the August round of figures were seen as solid, while the September PMIs saw the official manufacturing PMI rise to 51.5, with new export orders above 50 for the first time in 2020, while the non-manufacturing index was 55.9, and the private Caixin manufacturing survey 53.0. The broadest measure of credit growth, total social financing (TSF), also continues to soar in y/y terms as the state ensures money flows to at least some parts of the economy.

In turn, however, that overlooks a recent Bloomberg [story](#) saying China, like everyone else, having a two-speed K-shaped recovery where some win big and yet hundreds of millions of people are being left behind, including small cities, small businesses, and migrant and rural workers.

One also can't forget that China's largest and most indebted property developer, Evergrande, has just had to make an opaque deal with "strategic investors" to prevent a default on its towering pile of debt, which threatened to ripple through China's USD 50 trillion financial asset markets. Yes, this is good news. But if the economy itself is so good, how was it able to get into such deep trouble in the first place?

Meanwhile, the PBOC is saying now is the time for "monetary normalisation" – but what that actually means is anyone's guess: higher interest rates and less credit is not one of the likely interpretations, however.

Figure 1: Mo' money



Source: Macrobond

Figure 2: Yet it buys you mo' USD(?)



Source: Macrobond

Then we come back once again to the ever-present risks of the geopolitical environment, where even by recent standards the news flow has been concerning. In particular, the editor of China's irascible English-language daily The Global Times tweeted out the following in late September:

"Based on information I learned, Trump govt could take the risk to attack China's islands in the South China Sea with MQ-9 Reaper drones to aid his reelection campaign. If it happens, the PLA will definitely fight back fiercely and let those who start the war pay a heavy price."

Obviously, we are not going to be basing any of our forecasts on this kind of rhetoric, but the kind of tail risks that this also points to – alongside similar messaging being sent to Taiwan, India,

and even Australia— makes for a strange backdrop for investors to be so bullish on the Chinese currency. Consider where the cross would be trading should this be true. Take the percentage chance of it occurring: how can CNY be stable as a result?

The same question stems from the US now adding China's largest chip-making firm to a blacklist due to its alleged military links, and China itself talking about the need for a 'long march' to achieve technological self-sufficiency.

Of course, China, like the rest of the world, will be waiting to see what emerges from the sharp-tongued and sharp-elbowed US presidential election – it is certain to be a near-term sentiment driver given the implications for tariffs, trade, and sanctions (and hopefully nothing worse!).

Until then, we shall continue to look for the upsides... and also how to avoid the potential downsides.

Table 1: Economic forecasts

	2019	2020	2021	Q1/20	Q2/20	Q3/20	Q4/20
GDP	6.1	1.2	4.7	-6.8	3.2	4.0	4.5
- Primary	2.9	1.0	2.5	-3.2	3.3	1.8	2.3
- Secondary	5.8	2.0	3.3	-9.6	4.7	6.0	7.0
- Tertiary	7.0	0.7	6.0	-5.2	1.9	3.0	3.5
Retail sales	8.1	-4.1	7.0	-18.1	-2.9	1.0	3.5
Exports	4.1	-3.5	3.9	-12.0	0.2	8.0	-10.0
Imports	0.8	-2.6	4.6	-2.5	-9.4	-2.0	3.7
CPI (% YoY)	2.9	2.5	3.0	4.3	2.5	2.5	2.5

Source: Rabobank

Australia

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Stop The Planet of the Apes, I Want to Get Off

I am reminded of the end of the original The Planet of the Apes movie. I mean the iconic scene where Charlton Heston gazes up in horror and realizes (spoiler!) that he has been on Earth all along: he is looking at the half-covered remains of the Statue of Liberty. I won't repeat what he says, but it's appropriate.

Why? As Bloomberg words it:

"Australia's government will loosen responsible lending laws in a bid to boost the flow of credit and help the economy recover from its first recession in almost 30 years... the government will scrap so-called responsible lending obligations for most forms of credit that it says have made banks overly cautious and stifled access to mortgages and other loans... The move is a turnaround from the findings of an inquiry into misconduct in the financial system, which called for banks to more strictly follow lending rules..."

In effect, the government has heeded what became known as the 'wagyu and shiraz' verdict...[where the] regulator had argued actual living expenses should be used instead of benchmarks, which have been criticized for underestimating how much people spend. As part of his ruling, Justice Nye Perram said borrowers can change their spending habits to service a mortgage: "I may eat wagyu beef everyday washed down with the finest Shiraz but, if I really want my new home, I can make do on much more modest fare."

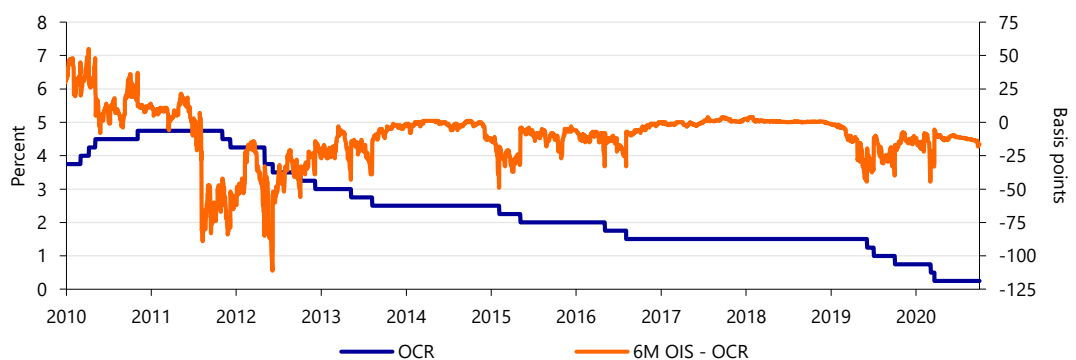
Lenders... will remain subject to APRA's lending standards, but will no longer be monitored by ASIC for compliance."

Let's put this into a broader context. This issue filled the papers for months. It was generally agreed that pretending everyone only ate beans on toast, rather than wagyu, so that all other income could be ploughed into a dangerously large mortgage relative to salary was not exactly an ideal way to run the Aussie housing market prudentially. Regulations were proposed and brought in under just that light.

And now..., all discarded and APRA is indeed Completely Redundant.

Australia is just one of many neoliberal, financialised, consumer-debt saturated, housing-bubble obsessed, low-productivity, low capital investment, infrastructure-poor Western economies. It was already stuck in the linked new normal of low wage, low GDP, and low productivity growth, and the lower quality jobs that come with it, albeit probably being 10-15 years behind the US on social and political polarisation. It is also being hit hard by Covid-19 and a closed border, and by serious trade tensions with China.

Figure 1: Another 15bp won't do it, but they are going to do it anyway



Source: Macrobond

The RBA has responded with zero rates and yield curve control out to three years, of which the latter is not stopping the market from pricing in more rates cuts (15bp, for example) as soon as this month (figure 1). The RBA has also said it will be there to support fiscal spending as needed. In short, the government has the ability to expand the fiscal deficit to a threshold determined only by the capacity of AUD to hold up.

And what is the government response? To tell banks to return to a housing bubble, exacerbating problems in society, making businesses less price competitive, starving non-housing firms of attention, making the banking system even more reliant on global wholesale money markets and, as the historical track record **everywhere** shows, eventually ending up in bad loans, which will be repackaged and sit with the tax payer. And making a mockery of the idea of prudent regulation.

THAT is where the fiscal capacity the RBA is offering is going. **I long said when the RBA goes full QE, it will be to buy shonky MBS rather than for a fiscal deficit for mega infrastructure projects... and that indeed seems to be the journey we are on.**

Central-bank financing of fiscal deficits admittedly takes us to the world of central planning, but here we have something worse: central planning with no plan.

Wagyu, Australia. Wagyu very much.

Of course, this is not an Australia-specific issue. But what we see here again is the utter failure of the imagination of those leading to realise that the old models no longer work. So many tools are now available to them to do something new – but that means abandoning deep-rooted dogma. As such, they prefer to stick to the tried and tested. Which is like watching someone try to eat the finest wagyu steak with a teaspoon. Or soup with chopsticks.

Yet this is going to matter to more than tradies. If the RBA is indeed one day soon going to be buying junk MBS to try to prop up the whole economy then AUD won't be holding a 7 or a 6 handle over time. The recent little dip was merely a warm-up, if so. Something far lower will ensue. There will be a lot more damage than that over time too.

[Stop The Planet of the Apes, I Want to Get Off.](#)

"You've finally made a monkey [but not] out of me!"

Table 1: Economic forecasts

	2019	2020	2021	Q1/20	Q2/20	Q3/20	Q4/20
GDP	1.8	-5.5	3.2	1.5	-6.4	-7.5	-9.0
Consumption	1.4	-7.6	3.0	-0.3	-12.7	-8.0	-9.0
Investment	-4.5	-10.0	4.0	-1.0	-5.4	-14.0	-17.5
Government	5.3	3.5	3.0	7.4	7.1	2.5	1.6
Trade	0.9	0.3	1.5	1.0	1.7	-0.4	-1.2
CPI (% YoY)	1.6	0.4	1.0	2.3	-0.5	-0.1	-0.1
Unemp. %rate	5.2	8.0	8.0	5.2	7.5	7.0	8.0
Unemployment rate	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Rabobank

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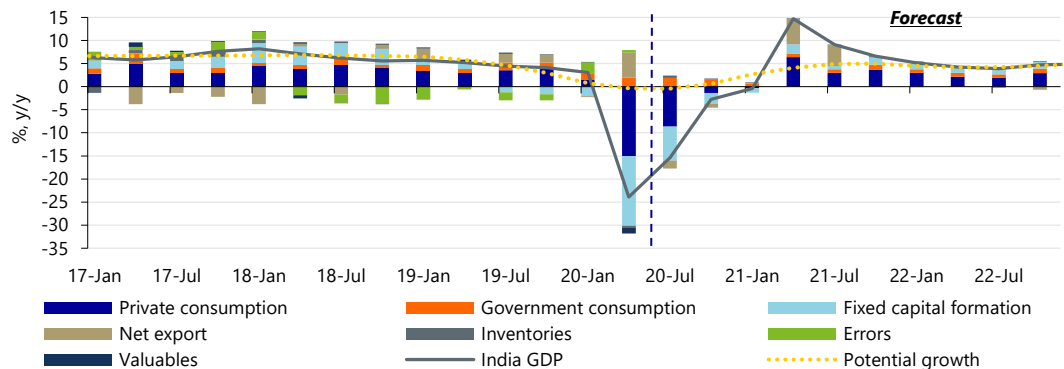
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Revising India's economic forecasts

We have revised our economic forecasts for the Indian economy downward to -10.6% for fiscal 2020/21 and expect the economy to grow by 8.9% in fiscal 2021/22 (figure 1 and table 1). For 2020Q3, we have pencilled in -15.4% y/y, with a contribution of private consumption of -8.6ppt and capital formation of -7.4ppt. The relief from additional government spending is marginal at best. Moreover, the economy is set to contract (in y/y terms) through the second quarter of 2021.

Figure 1: GDP in Q3 is also expected to show a large contraction



Source: RaboResearch, National Statistical Office, Macrobond

Why the revisions?

Although we have been relatively accurate in predicting the impact of the hard lockdown phase in Q2 (-19.8% y/y versus consensus -18.1%), monthly data on important economic indicators show that we probably have been too bullish on the pace of the recovery after the hard lockdown. Oil consumption and steel production still contracted by double digits in July and August, industrial production registered -11% y/y in July, services sector PMIs are looking bleak and consumer confidence is at rock bottom. The weak pace of the recovery is directly linked to (local) lockdown measures being kept in place, which are heavily restricting economic activity. Given India's relatively young population (28 is the median age), the relatively low mortality rate and a large share of people with low incomes (for whom the restricting measures have been particularly devastating), we assumed that policymakers in India would phase out restricting measures at a much faster pace than what we are currently seeing. In fact, India's stringency index even rose from 75 early June to 81 currently (100 = maximum stringency).

Not many policy options left...

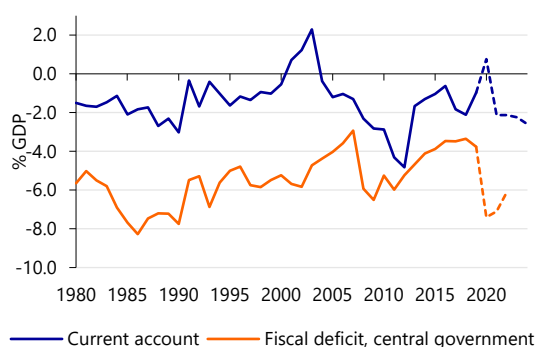
Against the backdrop of a struggling economy, the question is what policymakers can still do. India has weak external and fiscal positions, which seriously limits its policy options (figure 2). We expect the budget deficit to deteriorate to -8.1% (of GDP) in FY2020/21 and -6.5% in FY2021/22. If the government would introduce additional fiscal measures, there is a serious risk of further downgrading of the sovereign credit rating by rating agencies, which could trigger severe capital outflows. So, probably no relief from the fiscal side. What about monetary policy?

MPC meeting postponed

The Monetary Policy Committee (MPC) meeting of this week has unexpectedly been postponed and new dates are announced shortly. Although the economy is in desperate need for further stimulus, inflation has been stubbornly high in India (figure 3). Since December 2019, inflation has hovered above the upper band target range (of 6%) of the RBI (except for April). Going forward,

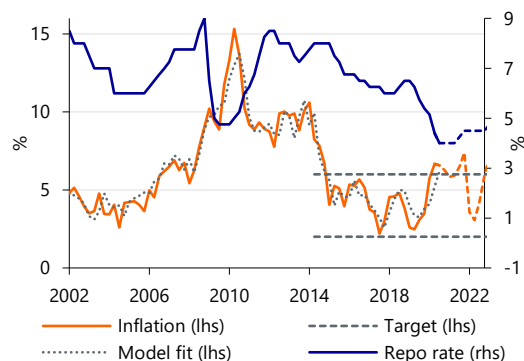
we expect food inflation to decline, as the impact of unfavorable base effects is expected to wear off and the monsoon produced 25% more precipitation in 2020 than the long-term average. Core inflation, on the other hand, is likely to be elevated, as [supply chain disruptions](#) due to local lockdowns have resulted in supply bottlenecks which pushed up costs. Further down the road, inflationary pressure may start to build up due to a sharp increase in Brent oil prices towards USD 50/bbl and we foresee global inflation picking up next year due to a recovery of global economic activity, resulting in higher import prices. Given the high inflationary regime and these risks, we think the MPC will be reluctant to cut its policy rates any time soon.

Figure 2: A weak external and fiscal position



Source: RaboResearch, Ministry of Statistics & Programme Implementation, Ministry of Finance, RBI, IMF, Macrobond

Figure 3: Inflation expected to remain elevated



Source: RaboResearch, Ministry of Statistics & Programme Implementation, Macrobond

Other options?

Given the fiscal and monetary policy gridlock, Indian policymakers should especially focus on improving the fundamentals of the Indian economy. The Modi government has recently been taking steps in the right direction: [new agricultural and trade bills](#) as well as reforms of labor market laws have been passed in Parliament in September. The F&A bills promote electronic trading, lower barriers for inter and intra-state trading, and enable farmers to sell directly to buyers, thereby clipping the middlemen and boosting farmer income. The [labor reforms](#) provide more flexibility to employers (with up to 300 employees) to hire and fire workers without government permission and offer social security to workers in the informal sector. But much remains to be done, for instance on land reforms, formalizing the economy and broadening the tax base. Currently, only 7.4% of Indian adults pay income tax (see [here](#)), which is much lower than in peers such as the Philippines (26%) and Vietnam (58%). As long as India's tax base remains small, the government won't have the financial means to conduct proper fiscal policymaking. Moreover, the banking sector continues to struggle and after the landmark Insolvency and Bankruptcy Act we have not seen much action by the government and RBI to clean up the sector.

Table 1: Economic forecasts

	FY2019/20	FY2020/21	FY2021/22	Q2/20	Q3/20	Q4/20	Q1/21
GDP	4.2	-10.6	8.9	-23.9	-15.4	-2.8	-0.4
Consumption	3.0	-6.3	4.0	-15.0	-8.6	-1.4	-0.3
Investment	-0.9	-6.4	1.4	-15.1	-7.4	-2.2	-0.9
Government	1.2	1.5	0.8	1.9	1.9	1.5	0.6
Trade	0.9	0.7	2.5	5.5	-1.7	-0.9	0.1
CPI (% YoY)	0.2	-0.2	0.1	-1.7	0.5	0.3	0.2
Unemp. %rate	4.8	6.2	5.1	6.6	6.3	5.8	5.9

Source: RaboResearch

Forecasts

Table 1: Economic Forecasts

	2019	2020	2021		2019	2020	2021
United States				Eurozone			
GDP growth	2.3	-6.2	1.3	GDP growth	1.3	-8.8	4.1
Inflation rate	1.8	0.7	1.6	Inflation rate	1.2	0.4	1.4
Unemployment rate	3.7	10.0	8.5	Unemployment rate	7.5	7.9	8.6
Japan				United Kingdom			
GDP growth	0.8	-4.9	2.9	GDP growth	1.5	-10.5	4.4
Inflation rate	0.6	-0.7	1.0	Inflation rate	1.8	0.9	1.4
Unemployment rate	2.4	4.0	3.5	Unemployment rate	3.8	5.7	8.3
China				The Netherlands			
GDP growth	6.1	1.2	4.7	GDP growth	1.7	-5.2	2.1
Inflation rate	2.9	2.5	3.0	Inflation rate	2.7	1.3	1.1
Unemployment rate	n/a	n/a	n/a	Unemployment rate	3.4	4.3	6.6

Source: Rabobank

Table 2: Swap rate forecasts

	1 Oct	3M	6M	12M		1 Oct	3M	6M	12M
USD					EUR				
Fed funds target	0.25	0.25	0.25	0.25	ECB depo rate	-0.50	-0.50	-0.50	-0.50
3m Libor	0.23	0.23	0.24	0.25	3m Euribor	-0.50	-0.52	-0.47	-0.39
2y swap	0.22	0.25	0.25	0.25	2y swap	-0.49	-0.40	-0.40	-0.50
5y swap	0.35	0.25	0.25	0.35	5y swap	-0.42	-0.35	-0.40	-0.50
10y swap	0.72	0.50	0.50	0.70	10y swap	-0.22	-0.10	-0.20	-0.20
30y swap	1.14	0.75	0.75	1.00	30y swap	0.00	-0.05	-0.10	-0.05
CAD					GBP				
Overnight target	0.25	0.25	0.25	0.25	Base rate	0.10	0.10	0.10	0.10
3m CDOR	0.51	0.44	0.44	0.44	3m Libor	0.06	0.15	0.19	0.26
2y swap	0.54	0.54	0.54	0.54	2y swap	0.07	0.15	0.20	0.30
5y swap	0.76	0.79	0.79	0.82	5y swap	0.20	0.20	0.30	0.40
10y swap	1.05	1.08	1.12	1.23	10y swap	0.40	0.40	0.50	0.50
20y swap	1.47	1.63	1.67	1.77	30y swap	0.59	0.50	0.60	0.70
MXN					TRY				
Overnight rate	4.25	4.25	3.75	3.50	late liq. Window	10.25	14.00	14.00	14.00
3m swap	4.52	4.28	3.78	3.70	3m TRY Libor	13.12	14.75	14.50	14.20
2y swap	4.50	4.67	4.60	4.63					
5y swap	5.08	5.33	5.36	5.50					
10y swap	5.87	6.23	6.37	6.59					
30y swap	6.70	7.26	7.38	7.58					
BRL					PLN				
SELIC target	2.00	2.00	2.00	2.00	3m Wibor	0.22	0.22	0.24	0.28
					2y swap	0.23	1.90	1.90	1.90
					5y swap	0.53	2.40	2.40	2.40
					10y swap	0.94	2.90	2.90	2.90

Source: Rabobank

Table 3: FX forecasts

	1 Oct	3M	6M	12M		1 Oct	3M	6M	12M
Majors					Central and Eastern Europe				
EUR/USD	1.17	1.16	1.14	1.18	EUR/CZK	26.94	27.00	26.50	25.50
GBP/USD	1.28	1.27	1.28	1.34	EUR/HUF	360.5	365.0	360.0	350.0
USD/JPY	105.6	105.0	105.0	111.0	EUR/PLN	4.50	4.60	4.55	4.35
USD/CAD	1.33	1.34	1.36	1.36	EUR/RON	4.87	4.90	4.85	4.80
AUD/USD	0.72	0.71	0.68	0.69	EUR/TRY	9.09	9.05	8.78	8.85
NZD/USD	0.66	0.65	0.64	0.66	EUR/RUB	90.77	92.80	88.92	87.32
EUR/CHF	1.08	1.07	1.07	1.10	Asia				
EUR/NOK	10.89	10.90	10.70	10.45	USD/CNY	6.79	7.07	7.30	7.60
EUR/SEK	10.49	10.50	10.40	10.30	USD/HKD	7.75	7.85	7.85	7.85
EUR/DKK	7.44	7.45	7.45	7.45	USD/IDR	14,835	15,370	15,677	15,210
Latin America					USD/INR	73.14	74.80	74.87	73.16
USD/BRL	5.61	5.35	5.40	5.05	USD/MYR	4.15	4.27	4.32	4.23
USD/MXN	21.88	24.00	24.00	24.50	USD/THB	31.60	32.61	32.94	32.28

Source: Rabobank

Table 4: Commodities forecasts

	Unit	1 Oct	2020Q3	2020Q4	2021Q1	2021Q2
Agri Commodities						
Wheat (CBOT)	USD/bu	577.75	535.00	545.00	550.00	550.00
Wheat (Matif)	EUR/t	197.25	190.00	192.00	192.00	184.00
Corn	USc/bu	381.75	365.00	375.00	370.00	372.00
Soybeans	USc/bu	1,030.25	970.00	965.00	960.00	965.00
Soy Oil	USc/lb	33.22	32.00	31.80	31.50	31.80
Soymeal	USD/tn	344.50	328.00	325.00	322.00	318.00
Palm oil	MYR/t	2,790.00	2,700.00	2,700.00	2,600.00	2,600.00
Sugar	USc/lb	13.52	11.80	11.80	12.00	12.70
Coffee (ICE)	USc/lb	109.60	112.00	114.00	116.00	117.00
Coffee (Liffe)	USD/t	1,295.00	1,380.00	1,420.00	1,420.00	1,420.00
Cotton	USc/lb	65.90	58.00	59.00	60.00	60.00
Energy						
Brent	USD/bbl	41.98	42.00	43.00	44.50	45.50
WTI	USD/bbl	39.89	37.50	38.75	40.00	41.00

Source: Rabobank

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