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War for longer

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Monthly Outlook

Michael Every
Global Strategist

Last month's outlook was titled 'Errrr… for longer', as it dealt with the various arguments over whether we were heading for a higher-for-longer rates environment or not. What sweet, innocent times they were. the issue for markets is no longer the uncertainty of 'Errrr…. for longer', which was bad enough. It is now the awful prospect of 'War for longer', as the global security order crumbles – and to what final end we don't know.

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Right now, the financial press is filled with headlines about war yet again, including appalling atrocities and communal tensions. while the Russia-Ukraine War is still grinding lives into blood and dust in the background.

As we made clear almost as soon as the Hamas attack on Israel occurred on October 7, the immediate economic and market impact of this latest round of Middle East conflict is still unclear. If, as is possible, the fighting remains focused solely between Israel and Gaza, then despite the awful human cost, the global hit is relatively minor. However, if Hezbollah opts to open a second front against Israel, and it and the US respond; and if Iran decides to help Hamas and Hezbollah via a multi-front destabilization against Israel and regional energy infrastructure – well, then we are looking at scenarios akin to 1973 or 1979.

For those who weren't around at the time, energy did what it did in 2022 and more; and against a tight labour market, and changes in the global financial architecture –where we had only just moved from the gold standard to full fiat currency– the result was a decade of very high inflation.

The tail risks should therefore be obvious. Yet for now the market struggles to incorporate these, in part because of the complexity of the situation and the wide range of outcomes, but also because tail risks are always uncomfortable to digest. However, the scenarios in which we see escalation from key players (Israel, Hamas, Iran, the US, and outside the region Russia and even China) are worryingly credible because both the ability and the incentives are there to do so.

It is not the case that nobody involved wants to see a real war. Only some don't – and they are geopolitical price takers, not setters. Indeed, some see this all as a geopolitical tipping point that can trigger a Western retreat, as from Afghanistan, so rewriting the global order. That's especially the case in an election year, when the US is desperate to avoid both higher energy prices and getting sucked into a new Middle East war. Yet every US opponent knows that, and is factoring it into their thinking.

Europe of course remains a spectator but still faces risks of: an oil price surge; an LNG price surge; the loss of access to the Suez Canal; the influx of millions of refugees; internal destabilization of parts of its society (look at the size of recent street demonstrations, for example); a US military shift away from Ukraine towards the Middle East; and a US demand for more military help, regardless of Europe's desire to avoid being sucked into the maelstrom. In short, Europe may find itself even deeper in a true Great Power struggle... with no great power.

Yes, calls for WW3 are over the top. However, it is entirely conceivable that we could see large-scale, missile-based wars in Ukraine and the Middle East simultaneously – and some then point to risks that fighting could spread to Asia if the US is distracted on two other fronts. After all, the global hegemon is over-stretched and under-resourced. Its capital has been misallocated for far too long for a more 'geopolitical' world: house and stock prices, or nifty apps, matter not at all in a real shooting war.

If there is one thing clear in this fog, it is this: we are not easily going back to the New Normal we saw from 2008-2019. We are already in a far deeper hole, one where geopolitical instability risks making everybody's job harder to do. Volatility will soar, despite central banks' desire to try to repress it. Ask the Bank of Israel how that has worked out for them lately.

In short, the issue for markets is no longer the uncertainty of 'Errrr.... for longer', which was bad enough. It is now the awful prospect of 'War for longer', as the global security order crumbles – and to what final end we don't know.

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Fixed Income

Authors
Bas van Geffen, CFA
Senior Macro Strategist
+31 30 712 1046

Return of the term premium

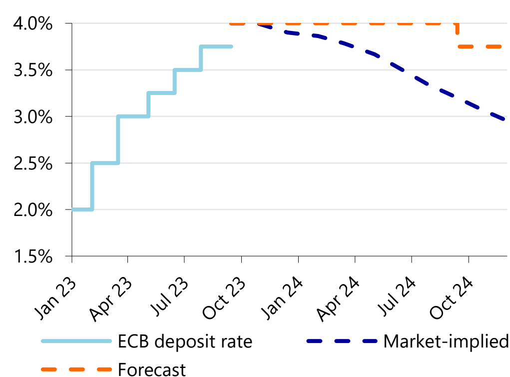
Much has changed over the past month. For most of October, markets were concerned just how high policy rates would still have to rise, and how long central banks would keep their policies restrictive. Mainly in the US, such uncertainty caused a pronounced steepening of the US Treasuries curve as term premiums rose to reflect the upside risk that the world is in a very different place than it was over the last decade or so.

The horrible events in the Middle East only added to these concerns. Although it's impossible to account for every scenario, risks of escalation leading to a potential new disruption of energy markets only added to the concerns that central banks may have to deal with another bout of energy inflation. Surely, monetary policymakers cannot look through another inflationary impulse at a time when inflation is still well above target, and is expected to remain elevated at least throughout the next year? With the energy crisis still fresh in peoples' memories, the risk that such an inflationary shock becomes entrenched in expectations is enormous.

Europe, in particular, is very much at risk given its energy dependence. One would expect the ECB to try and sever the link between a possible new energy shock and inflation expectations before such a scenario materializes. Nonetheless, the ECB did not provide much in the way of a reaction function for such an eventuality. In fact, President Lagarde took a much more balanced approach, noting that an energy shock would apply to a very different economy today: *"We have to take all factors into account to see how possibly higher energy costs would affect* ***both GDP and inflation****,"* she concluded (emphasis ours).

This balanced tone perhaps dispelled some of the markets' concerns that the ECB might extend its hiking cycle in December or early 2024. In fact, in the wake of the ECB meeting markets are increasingly eyeing the possibility of a first rate cut in the second quarter. However, the decline in 1-year rates isn't (fully) being reflected further along the yield curve, as illustrated by the steepening of the 2y10y Bund spread, for example. This, again, suggests that the term premium is an increasingly important factor for the curve. In other words, even though the median trader still has rate cuts as their baseline scenario, they are increasingly accounting for a range of alternative scenarios amid the latest geopolitical developments.

Figure 1: Money market prices four ECB rate cuts next year



Source: Bloomberg, Rabobank

Figure 2: But curve steepening flags concerns about alternative scenarios

Source: Bloomberg

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The alternative scenario: "Rate hikes and acronyms"?

We agree with President Lagarde that the economy is in a different state. From a purely economic viewpoint, another energy price shock could perhaps be classified more as a traditional supply shock than the 2021/2022 combination of a post-pandemic surge demand and an energy crisis. Households, businesses and governments all have smaller buffers than they did a few years ago, and growth may therefore take a bigger hit when prices spike. Thus, in isolation, a potential new energy shock may require more monetary policy restraint than what we have seen over the past two years.

But politics have changed as well. Domestically, social unrest is rising as a result of the high inflation and the impact on peoples' livelihood and standards of living. And ever since the Ukraine war broke out European thinking on security and defense has slowly been shifting. Should the situation in the Middle East escalate, it's plausible that these concerns will only increase. From that point of view, it is hard to see how European governments could stand by in a scenario of severe escalation. Defense spending may have to be ramped up and subsidies may have to be rolled out again to ensure that people have access to food and heating. Particularly in resource-scarce Europe, this may require governments to allocate those commodities that are in shortest supply.

In such a scenario, it's easy to envisage how the hit to Eurozone GDP may be dampened by the military complex and fiscal spending. However, it is also abundantly clear that a combination of the abovementioned policies would be inflationary beyond just the energy shock. Against a backdrop where inflation is already well above target, this would clearly force the ECB to hike further and keep policy rates at high levels for longer.

That no-brainer policy response could easily turn into a headache, though. Governments have exhausted much of their fiscal space during the previous crises. And that was when yields were still at historical lows. Already, the global hiking cycle to date is adding to governments' funding costs and long-term yields are at such levels that there are increasingly concerns about the sustainability of some countries' debts – Italy being the prime example. And that's without the additional costs of the abovementioned fiscal intervention. Further rate hikes would only exacerbate this problem, and may reawaken Eurozone fragmentation risks.

'Fortunately', the ECB has several tools at its disposal to deal with these potential side effects. The first one that comes to mind is the Transmission Protection Instrument that was introduced at the start of the hiking cycle. Recall that the TPI could be activated at the ECB's discretion, in the event that an unwarranted widening of spreads would lead to an uneven transmission of the monetary policy stance across all parts of the currency union. Of course, it can be debated whether such a widening would truly be 'unwarranted', given the fiscal position of some member states. However, it can equally be argued that spread widening is at least partly an unintended consequence of the ECB's fight against inflation.

Or perhaps the ECB will simply add a new abbreviation to its policy toolkit, like it did with the PEPP. Let's not forget the ECB's creativity over the past decade and a half. The backing for 'acronyms' is likely to be stronger in the case where the shock stems from some external factor, rather than being the product of domestic policies or choices. The Covid-shock was a prime example, but disruptions caused by a broadening Middle East conflict rather than 'overheating' concerns could well be viewed in a similar way.

As such, although markets are currently looking at the peak of the cycle and the potential timing of rate cuts, a severe escalation could easily see central banks pursue a policy mix of 'rate hikes and acronyms'.

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Foreign Exchange

Author
Jane Foley
Senior FX Strategist
+44 20 7809 3000

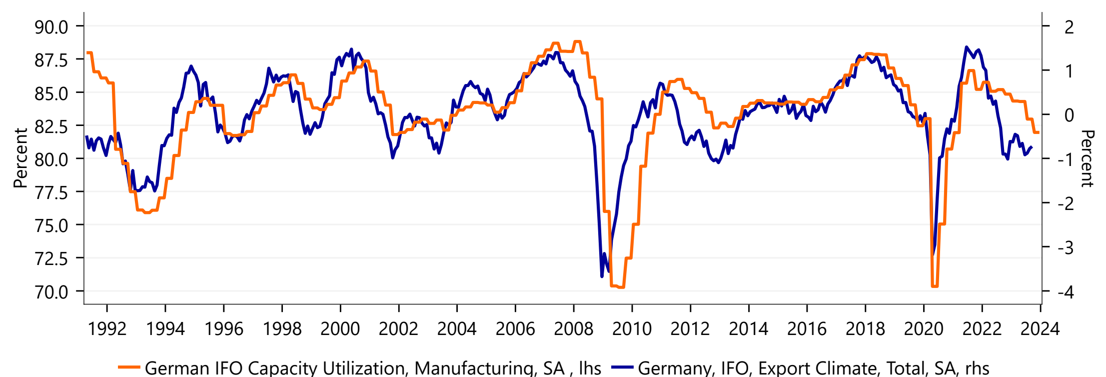
EUR/USD: change of tack?

Economic data have made it clear that the German economy remains mired in stagnation. Nevertheless, EUR/USD pushed higher in October as the market reacted to the recent failure of the USD to find buyers vs. the single currency despite the relatively better tone of US economic data and the news stemming from the Middle East. Measured to October 31, since the start of the Israel and Hamas war only the safe-haven CHF and the EUR (and thus DKK) have managed to outperform the USD in the G10 space. In our view, fundamental factors suggest that the EUR's tenacity will be brief. We maintain a 3-month forecast of EUR/USD 1.02.

Eurozone GDP for the quarter has registered a contraction of -0.1% q/q. Although there was considerable variation in the performance of the member states, the overall number fits the Rabobank projection of a Eurozone recession in the second half of this year. In tune with the slowdown in activity levels, Eurozone CPI inflation has also softened. The October estimate for Eurozone CPI inflation stands at 2.9% y/y, well below the consensus forecast of 3.1% y/y. Although energy prices may contribute more to the headline rate later in the year, the overall picture is one of gradual disinflation in the Eurozone which will promote the view that ECB interest rates have peaked. Indeed, while policymakers will be reluctant to talk about the outlook for rate cuts as long as inflation remains above the ECB's 2% target, the market is speculating about such a move in 2024Q2. Market implied policy rates currently put ECB rates around 20bp lower than current levels on a 6-month view. By contrast, Fed rates are seen at the same as current levels in this timeframe, with the market projecting a modest uptick on a 3-month view.

Since fundamentals do not appear to justify a EUR recovery, we expect that its October resilience is a function of position adjustment related to the strong sell off in EUR/USD in recent months. During this period the market adjusted to the 'higher for longer' outlook for US rates and absorbed a lot of bad news regarding the German economy. That said, in view of the stagflationary position of Europe's largest economy and the recessionary risks facing the Eurozone as a whole, we expect that the EUR's upside potential will run out of steam.

Figure 1: Germany's IFO index



Source: Macrobond

AUD/USD: waning risk appetite

The minutes of the RBA's October 3 policy meeting displayed a clear hawkish bias. This appeared to be vindicated by the strength of recent Australian economic data. Not only was Q3 CPI inflation stronger than expected, but retail sales reflected a far greater degree of resilience in the consumer sector than had been forecast by the market. The data have underpinned our expectation for another 25bp rate hike from the RBA at the November 7 policy meeting. While interest rate

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differentials have appeared to be supportive for AUD/USD, particularly given expectations that the Fed would leave rates on hold in November, the currency pair has struggled to find traction.

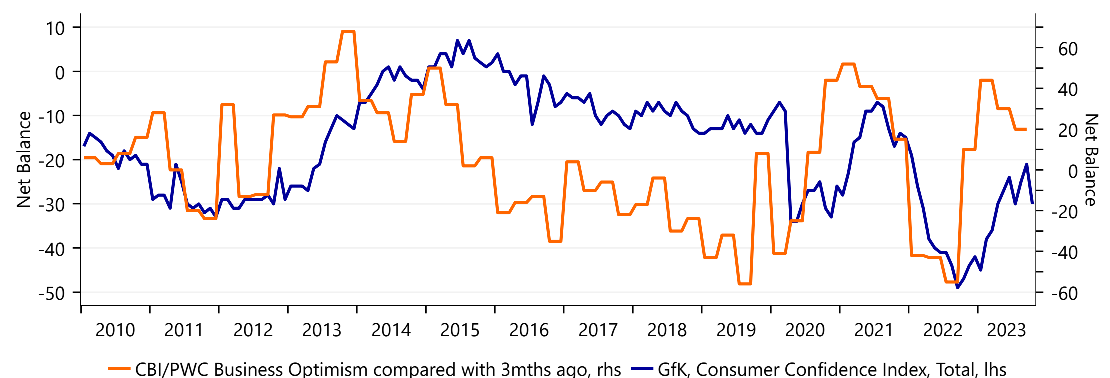
Traditionally the AUD is sensitive to the overall level of risk appetite. This is linked to Australia's large-scale commodity exports, the performance of which is typically related to world growth. Since China is the world's largest consumer of commodities and Australia's biggest export partner, the AUD is particularly sensitive to risks associated with China's growth outlook. While China's growth has disappointed this year, aided by the loosening of Chinese tariffs on some Australian export products, Chinese data reportedly suggests Australian trade to China have rose in the first nine months of the year. Australian exports of commodities including barley, coal and timber to China resumed earlier this year. Barriers remain on wine, lobsters, and meat from some abattoirs, but PM Albanese recently signalled he is optimistic about a breakthrough on wine. That said, against the backdrop of tighter monetary conditions and weaker global growth, the Australian economy is set to experience a slowdown next year. On balance, we expect USD strength and poor levels of risk appetite to cap upside potential in AUD/USD in the months ahead. That said, we would look to sell rallies in EUR/AUD and see scope for a move to 1.59 on a 6-month view.

EUR/GBP: new ground?

The September decision by the BoE to leave rates unchanged was a close call. The move, which surprised many commentators, triggered a revaluation of the outlook for BoE policy into next year. Given that UK economic data are worsening, the market now sees only a slim chance of further rate hikes this cycle. The shift in market rates has weighed on the pound and pushed EUR/GBP above the 0.87 level, which had been the top of the range that had largely contained the currency pair since late spring. The souring of UK economic data reflects the cumulative impact of the Bank's policy tightening. Consumer confidence in October dropped and retail sales have weakened. That said, German economic data have also been weak. The German economy shrank -0.1% q/q in Q3, confirming the prevalence of stagnation. In addition, German CPI inflation fell more than expected in October, to 3.8% y/y. Although the ECB did hike rates in September, the sentiments expressed by President Lagarde in October were a little more dovish. This should limit scope for additional appreciation in EUR/GBP in the months ahead, particularly in view of market speculation that the ECB could be cutting rates in Q2 next year.

Overlooking the risks of an oil price shock, it is likely that tight labour markets and sticky inflation pressures will remain a concern in most G10 markets going forward. This implies scope for caution from both the ECB and the BoE. That said, UK inflationary pressures are proving to be particularly stubborn. This suggests that BoE policy will be stuck on 'Table Mountain' for some months. While the ECB is likely to push back on expectations of an early interest rate cut as long as inflation remains above target, market speculation that the BoE will be the latter of the two to cut rates suggests scope for EUR/GBP to drop back below the 0.87 on a 1-to-3-month view.

Figure 2:UK confidence surveys



Source: Macrobond

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Agri Commodities

Authors
Carlos Mera
Head of Agri Commodities Markets Research
+44 20 7664 9512

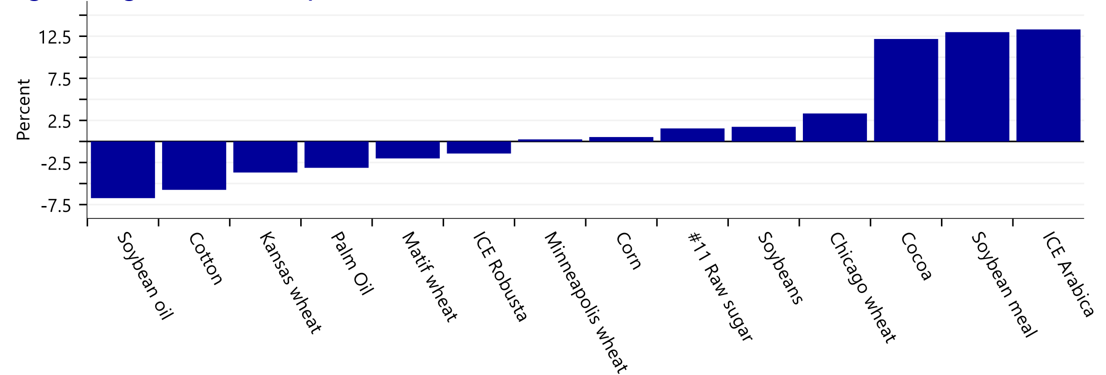
Michael Magdovitz
Senior Commodities Analyst
+44 7418 73 7925

Paul Joules
Commodities Analyst
+44 7887 82 4436

A wet blanket for volatility

The S&P GSCI Agriculture Index traded in a range in October amid mixed US export sales, improving Southern Hemisphere prospects, strong Russian export data and concerns regarding Brazilian export delays. CBOT Soymeal and ICE Arabica futures recorded the largest gains within the month amid strong exports and heavy short covering by managed money. For consumers, they are more than happy to take cover under the wet blanket as weakening commodity prices are now beginning to seep into supermarkets with recent CPI data pointing to price deflation across many regions.

Figure 1: Agri commodities price movements from 1 October to 31 October

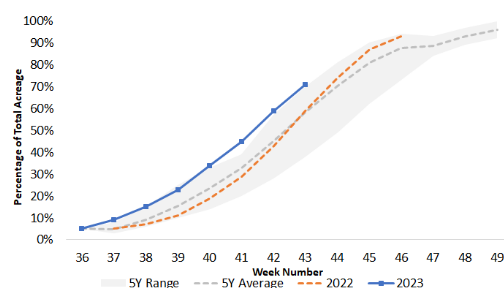


Source: Bloomberg, Macrobond, Rabobank

The soy "complex" is acting the part

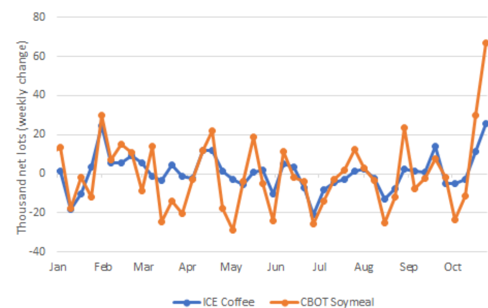
Late season Brazilian and Argentine soybean export sales have delivered demand relief to a poorly-supplied US soybean balance sheet. In contrast, US soymeal export demand has been exceptionally strong, up 43% y/y, amid Argentina's shortfall. Following comments from the CEO of a major agri trader predicting Argentine crushers will run out of beans by November, funds and commercials have been scooping up CBOT contracts the last few weeks, fearing a squeeze. The latest managed money purchase of CBOT Soymeal was the second largest on record. South American plantings are gaining pace though, and the period of US reliance – except as a reserve – will be short-lived. In sharp contrast to CBOT Soymeal's contract highs, CBOT Soy Oil touched 4-month lows last week, as managed money sold heavily and consumers sat back amid the larger-than-normal premium versus other vegetable oils. 2022/23 showed remarkable demand rebound for rapeseed and palm oil, led by India and China, which is in turn buying time for soy oil supplies to rebound.

US corn harvest is pressuring global prices (71% complete as of end-October)



Source: USDA, Rabobank

Managed money have ramped up their net CBOT Soymeal and ICE Arabica positions



Source: CFTC, Rabobank

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Global wheat futures shrugged off the temporary closure of Ukraine's grain corridor as Russia continues to retain export supremacy

Although CBOT did bounce slightly higher on the news, fears were quickly alleviated as the corridor is now back in operation, albeit slowly. Meanwhile, high volumes of Russian wheat exports show no signs of slowing and continue to weigh on global wheat markets. Preliminary October export data looks strong, supported by a weak ruble. The RUB/USD cross, despite a 10% rally over the past 3-weeks, remains 32% weaker year-on-year. In recent weeks it was rumored that Russia had set an unofficial price floor for wheat, but those fears appear unfounded, with offers well below that level.

Crop conditions in the Southern Hemisphere appear to be improving modestly. In the past week we have seen rains over parts of the Argentine wheat area, and the 7-day forecasts predicts more of the same with Cordoba, Santa Fe and Buenos Aires all set to receive more rainfall. We do not anticipate the recent switch to wetter weather to significantly improve prospects, but it will prevent further losses. In a similar vein, small pockets of the Australian wheat area have also added more rains to the 1-week forecast, with parts of NSW set to receive some much-needed rainfall.

ICE Arabica futures rose 11% in October

The only link between the physical coffee market and the latest futures rally seems to be the delays to Brazilian exports (shortage of trucking and containers). In our view these are relatively short-term issues: The coffee is there. Despite the concerns, October exports have actually been good out of Brazil, with green coffee exports totaling 2.96 million bags in the first 27 days of the month, which is 33% higher than last month. The other factor contributing to the recent price rise is speculator activity, the latest CFTC report highlighted that managed money purchased 25.5k net lots in the week ending October 24 – the second largest weekly net purchase on record! The lion's share of this was short-covering, however we did also see some fresh longs.

Energy Markets

Author
Joe DeLaura
Senior Energy Strategist
+1 212 916 7874

Geopolitics add more volatility to unbalanced markets

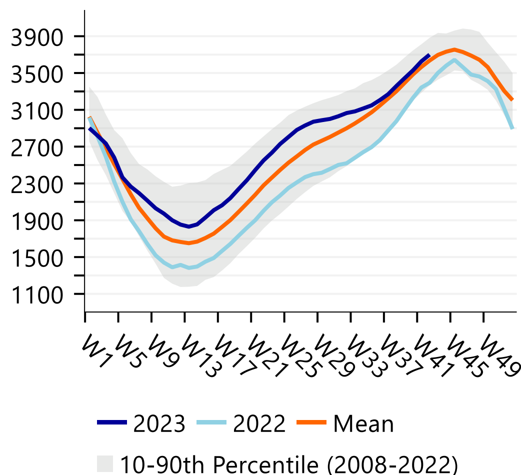
European benchmark TTF gas prices rose by around 20% in October on the month, reaching a monthly high of €54/MWh on October 13, as the Hamas attack on Israel and Israel's subsequent ground invasion of Gaza sent prices soaring. TTF prices had not risen above €50/MWh since April.

The latest Israel-Hamas war has raised supply concerns for European gas buyers at a time of gradually rising gas demand as winter approaches. Production stops to Israel's gas fields have only a marginal impact on the European gas balance through reduced flows to Egypt's LNG supply to the Mediterranean market. The wider risk premium however stems from potential disruptions to flows through the Strait of Hormuz and the Suez Canal – two major routes for oil and gas shipments from the Middle East to Europe.

Lower natural gas demand in Europe and the UK as well as strong LNG imports and high underground storage fill levels have reduced some of the upside in prices. Additionally, a ramp-up of Norwegian gas deliveries to Europe and the UK after a series of outages and annual maintenance from August-September will keep prices moderated. Norwegian nominated gas flows to Europe rose to 305mcm/d in October from 271mcm/d in September and from 181mcm/d in August.

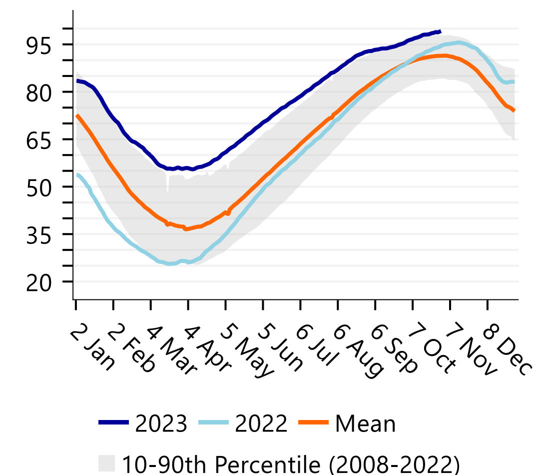
Global LNG flows to the world's largest buyers –Asia and Europe– ticked up in October on the month, with the JKM-TTF spread wide enough to incentivize US LNG shipments to Asia ahead of Europe. Current forward spreads between the two regions still point to higher profitability for US-Asian flows in December through to February. Japanese and Chinese LNG storage is plentiful, with both able to draw down storage if necessary to avoid more expensive spot LNG cargoes, while EU gas inventories are well above 95% full. The EU will continue to buy spot cargoes to meet domestic demand for the time being as forward prices continue to incentivize leaving gas in storage tanks. This leads to our continued belief that €55/MWh is a ceiling until the first major cold waves begin to hit.

Figure 1: US natural gas inventories faced a hot summer and flatter builds, a cold winter will see $3.5-4.0/MMbtu prices easily



Source: Bloomberg, EIA, RaboResearch

Figure 2: EU gas inventories are well above average, stabilizing TTF prices for the time being in the high-€40s to mid-€50s



Source: Bloomberg, GIE, RaboResearch

In the US, Henry Hub gas futures also rose above an average $3.10/MMBtu in October from just over $2.70/MMBtu in September, with the highest daily price recorded on October 10 at $3.382/MMBtu. Cooler weather forecasts and below-forecast storage injections last week drove recent bullish sentiment and the break above $3 in line with our analysis from last month.

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Crude oil & refined products

Brent started with a massive, bearish drop, followed by a surge of volatility from the beginning of the Israel-Hamas war. Eroding gasoline demand and overall bearish economic sentiment has traded against strong diesel demand and now another geopolitical support. We are revising our Brent forecasts down slightly throughout 2024 but we are still bullish overall. The main adjustments are extending the lower range of our forecast to the end of 2024, with $75/bbl now as our most bearish price scenario for the year.

Figure 3: Brent's breakout has been halted by worsening macro demand and slumping gasoline, but geopolitical threats will send another attempt at $100 in Q4 with downside to $82 possible

Source: Bloomberg, RaboResearch

In the aftermath of the attack on Israel this month, market fundamentals are mixed. There have been no disruptions to physical crude supplies from the current geopolitical turmoil. **A deeper correction may be brewing.** 2023 has been marked by a significant supply deficit, deepening as OPEC+ output has been curtailed while demand has been broadly robust. However, US gasoline demand, which makes up about 45% of total US products demand, has had several notably weak data points in the last months. One such point can be waved off, but three signifies that something is happening at the macro level. Brent front-month spreads are a solid indicator that prices are in a bullish trend; but spreads have narrowed from $2/bbl to just $0.75, showing a loosening market. Cargoes of WTI and Murban crude are also trading weaker due to China considering cutting refinery runs as gasoline crack spreads have declined in profitability.

Bullish factors are that worldwide stockpiles of crude oil remain at a six year low, and the key US storage hub of Cushing, Oklahoma, has hit the lowest levels of the past decade in October, close to operational minimums. Higher interest rates reduce the incentive to hold on to crude oil stockpiles, and also discourage new investment and capital expenditures on the upstream (exploration and new production) side. While backwardation has weakened in the last few weeks, the structure still remains, forcing traders to sell barrels in the prompt physical market rather than hold onto barrels into the future.

Overall, we remain long-term bullish. Supply growth for crude and a lack of new refinery capacity over the next decade will weigh against still-growing demand for oil products. The battery-electric vehicle revolution is still nascent, and the technology to displace diesel demand is still far off and unlikely to affect the market until the 2030s. Current diesel inventories and demand support prices well above $3/gal for ULSD and $880/mt gasoil for the next quarter.

Eurozone

Author
Elwin de Groot
Head of Macro Strategy

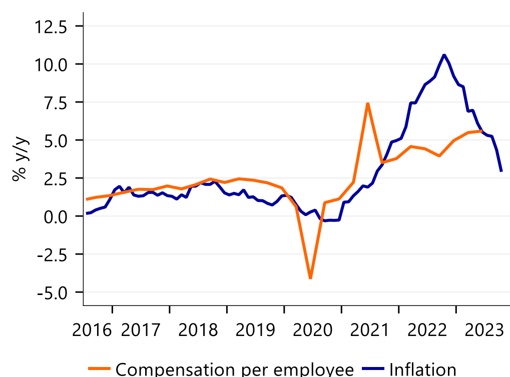
Economy slips as inflation slows

On the economic front, things have largely played out as expected. The economy contracted by 0.1% q/q in Q3, in line with our projections, albeit with a significant divergence among member states. Preliminary details from several member states indicates that household consumption was weak, but slightly stronger than in Q2. Exports likely acted as a drag on growth and construction activity was weak. On an upbeat note, business investment in machinery and equipment seems to have held up, despite higher interest rates. This could point to capital for labor substitution in light of the tight labor market. Still, we also believe that it will take longer before the pain of higher interest has fully materialized. Meanwhile, inflation has come down significantly in recent months, with headline falling below 3% in October. This decline, however, is being led by energy, food and goods items, rather than services. The pressure for the ECB to keep hiking has receded, although we expect them to keep rates on hold well into 2024.

A mild recession, then?

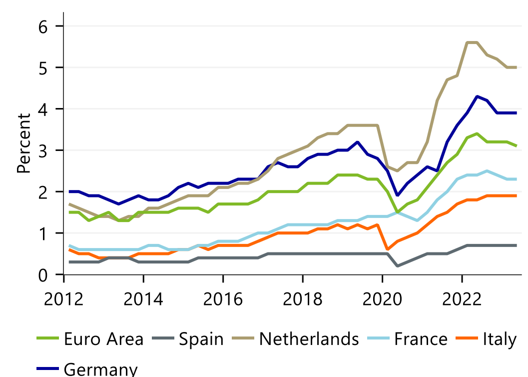
What is perhaps most remarkable is that, despite the 2021/22 energy shock, it took so long for the Eurozone economy to slip into a recession. We see several explanations for this. First of all, some economies continued to 'benefit' from post-Covid pent-up demand, backlogs and the need to replenish inventories. This is no longer the case, especially as global demand has cooled. Secondly, pandemic savings acted as a buffer during the height of the energy crisis. This no longer applies either, as they have been entirely eroded by higher prices. Thirdly, governments took measures in 2022 and early 2023 to alleviate the impact of energy prices on households and businesses. Those measures have been partially unwound now, but note also that the EU budget rules have been suspended since 2020 and government investment, spurred by the NGEU/RRF, started to accelerate from mid-2021. Next to labor shortages, this is one explanation for the relatively slow deceleration in investment spending. Fourth, more recently the sharp deceleration in headline inflation, combined with an acceleration in wage growth, has turned into a more favorable development for households, in particular while the labor market continues to be tight.

Figure 1: Inflation below wage growth now...



Source: Macrobond

Figure 2: ... as vacancy rates are still high



Source: Macrobond

We expect that the Eurozone economy will also shrink in Q4 (and probably a little bit more than in Q3), making this a mild recession. Over the course of 2024 growth should recover, but sluggishly. Higher interest rates will continue to keep a lid on growth and uncertainty may also affect investment spending, despite the fact that the tight labor market and the 'need' to invest in strategic sectors, energy transition and so forth, will attenuate this. We expect labor market pressures to ease. Forward-looking indicators, such as the purchasing managers indices, indicate that European firms cut employment in September, the first drop in headcount since the early 2021 lockdowns. Still, the labor market looks set to remain structurally tight and unemployment is

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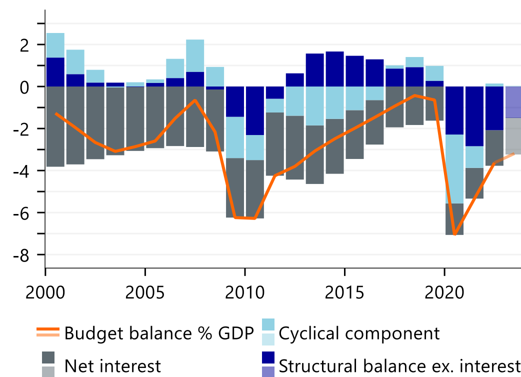
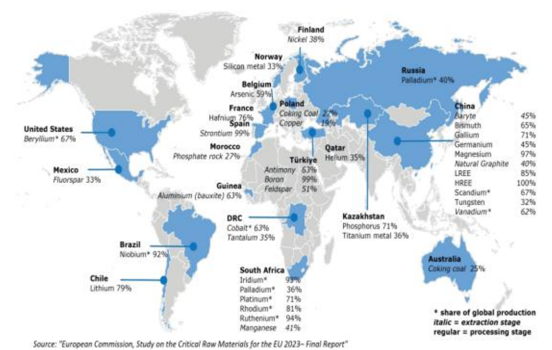
to rise only mildly due to labor hoarding. This both puts a floor under any economic contraction (since consumers can uphold their consumption) and a lid on economic growth as companies struggle to find qualified workers. Foreign demand is probably not going to substantially lift the Eurozone growth figure, as we expect a struggling Chinese economy and a US recession in 23Q4-24Q1. Overall, and in the absence of new major shocks, we see the economy growing by 0.5% in both 2023 and 2024. This scenario would also imply a gradual decline in core inflation, but with risks to that trajectory tilted to the upside, given the tightness of the labor market.

Figure 3: Structural budget balance only little better than in 2009/'10



Source: Macrobond

Figure 4: EU's high dependence on key strategic raw materials makes it vulnerable to disruptions



Source: EC

Yet, war is our minds

There are serious risks to this scenario, however. The most obvious one being a further escalation of the war in the Middle East, which could lead to a big jump energy prices. Its economic impact could be bigger than it was last time around. Governments no longer have the same fiscal firepower to cushion the blow, due to the increased cost of borrowing and structural deficits (figure 3), whilst most consumers can't rely anymore on a glut of pandemic savings. Meanwhile, companies are also in a weaker position to handle a new energy price shock. They already face significantly higher financing costs and increasing labor costs, whilst the slowing economy means that they probably can't fully charge those higher costs to their customers. The economic price of a renewed energy shock could therefore be larger.

Next to that, if a war in the Middle East also ruptures major supply chains or leads to further tensions between the big economic blocs, Europe could be very vulnerable, given its high reliance on raw materials. Large displacements of people from the region could also confront European policy makers with new challenges.

Table 1: Economic forecast

	2022	*2023*	*2024*	*Q1/23*	*Q2/23*	*Q3/23*	*Q4/23*
GDP	3.4	0.5	0.5	0.0	0.3	-0.1	-0.1
Consumption	4.5	-0.4	0.4	-0.3	-0.1	-0.2	-0.1
Investment	3.0	1.3	0.6	0.6	0.5	0.1	0.1
Government	1.4	-0.7	1.1	-1.6	0.3	0.2	0.2
Trade	-0.3	0.7	0.0	0.7	-0.1	0.1	0.0
Inventories	0.2	-0.2	-0.2	-0.3	0.3	-0.1	-0.2
CPI (%y-o-y)	8.4	5.6	3.5	8.0	6.2	5.1	3.7
Unemployment rate	6.7	6.6	6.6	6.6	6.5	6.6	6.7

Source: Rabobank

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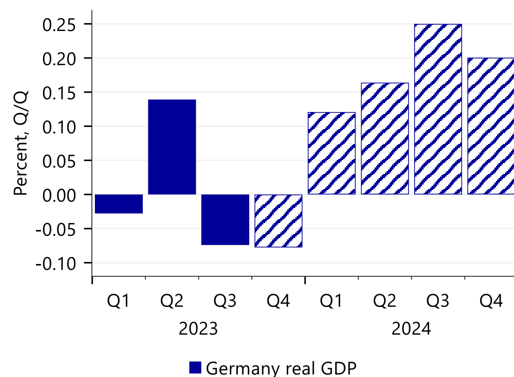
Germany

Author
Erik-Jan van Harn
Macro Strategist

A shallow recession

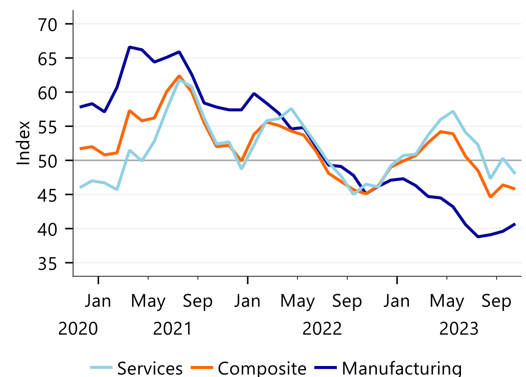
The German economy shrank by 0.1% in the third quarter, which is slightly better than expected. Still, Germany's prospects are not particularly bright. Sentiment indicators point to a continuation of the contraction through the current quarter, which is consistent with our forecast. Furthermore, we anticipate that economic growth will be sluggish after that. Interest rates are likely to remain high for some time, and the ECB's bank lending survey clearly shows the negative impact on loan demand – and thus business investment. Furthermore, we anticipate that the labour market will remain tight (more on this later). This puts a floor under the economic contraction (no deep economic recession has ever occurred without a rapidly increasing unemployment rate), but it also puts a lid on future economic growth as companies struggle to find the right personnel for the job.

Figure 5: Is Germany set for a recession?



Source: Macrobond, RaboResearch

Figure 6: According to the PMIs: Yes



Source: Macrobond, RaboResearch

Despite the fact that the prospects for continued subpar growth are particularly bleak, they may be advantageous in the short term, as they increase the likelihood of a soft landing. German inflation is rapidly losing steam. Prices in October were only 3% higher than a year earlier, owing primarily to lower energy and food price inflation. Furthermore, forward-looking indicators such as the PPI and PMIs indicate that disinflation is likely to persist in the coming months (excluding the strong base effects for energy prices).

However, there are clear risks to the outlook for the German economy. The energy crisis has made abundantly clear how vulnerable German industry is to rising energy prices. Energy-intensive industries continue to lag far behind their less energy-intensive peers. An escalation in the Middle East conflict could exacerbate the situation for those companies, as energy prices are likely to rise. While the German government is still well placed to provide support where it is needed, any such support will probably be less than the last time because interest rates are beginning to weigh on the government's budget. Furthermore, businesses are already facing high energy costs, while labour costs are rising and demand is decreasing. This time around, a new energy shock will probably hurt companies more than it did last time.

Will the German labour market finally get some slack?

The labour market in Germany is notoriously tight. The unemployment rate is currently 3% (ILO definition), which is very close to the lowest level since the country's reunification in 1990. Furthermore, the vacancy rate (which can be viewed as an additional demand factor for labour) is at 4%, the highest reading since data collection began. Not surprisingly, a large proportion of German businesses report that a lack of qualified workers is impeding their output. That is much higher than the average for the Eurozone.

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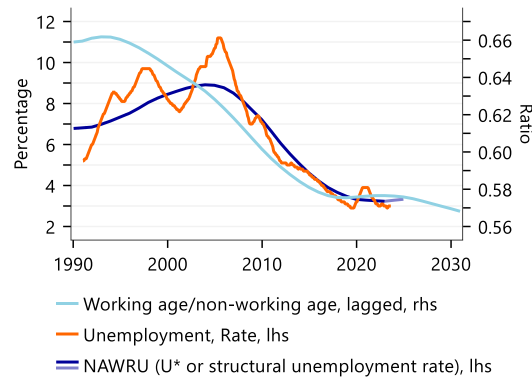
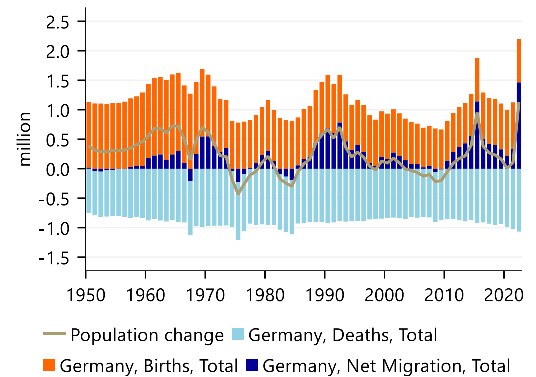
However, some easing may be on the way. The number of unemployed people has actually increased slightly in the last few months, while companies' employment expectations for the coming months have also cooled slightly. This may sound encouraging, but we do not anticipate a significant loosening. To begin with, the vacancy rate, which serves as a buffer against an increase in the unemployment rate, remains at an all-time high. Furthermore, there is evidence of labour hoarding, as companies do not intend to reduce their workforce, despite the fact that the economic outlook, particularly in the manufacturing sector, is bleak. This is further supported by the fact that the *Kurzarbeit*-schemes allow businesses to furlough employees at a low cost.

Figure 7: A sign of a structurally tight market



Source: Macrobond, OECD, Destatis

Figure 8: Is immigration a solution?



Source: Macrobond, Destatis

The current problems in the German market may provide a glimpse of what is to come. Germany's demographics are analogous to an oil tanker on a collision course with the quay; slowly approaching but impossible to stop. There were roughly five people of working age for every retiree in the 1960s; by 2050, that number is expected to drop to just two.

The German government can only do so much to turn the tide. And the majority of these policies will only postpone rather than solve the problem. The German government could, for example, raise the retirement age or provide incentives for people to work after they retire. However, the current trend is that people prioritize working fewer hours, as many have re-evaluated their work-life balance as a result of the pandemic. This only exacerbates Germany's problems.

Immigration is the only short-term solution that would make a significant difference. The German government has already passed legislation that should help skilled immigrants find work in Germany. While this is a step in the right direction (at least the government recognizes the issue!), it probably will not be sufficient. The working-age population is expected to decline by nearly 700,000 people per year until 2035. This number of people only migrated to Germany during the 2015 refugee crisis and again in 2022, when the war in Ukraine began. We shouldn't expect much from this side either, given the potential political sensitivity of migration. We may have to accept that Germany's labour market will only tighten further.

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The Netherlands

Author
Lize Nauta
Economist

Waiting for the elections

The Israel-Hamas war currently dominates the news, including in the Netherlands. The economic implications for the Netherlands are very small at the moment and limited to companies that deal directly with this region, for instance, travel agencies. It is hard to forecast how the war will develop, but if there is further escalation, e.g. along the lines of one of these scenarios, the impact for the Dutch economy could be larger.

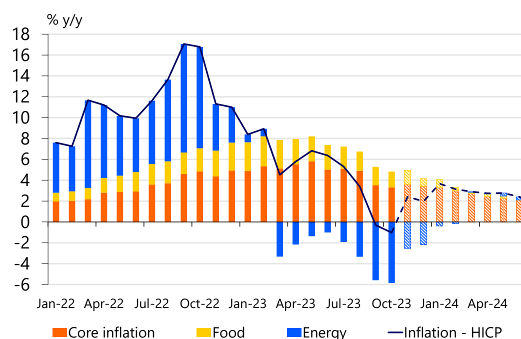
Amid these geopolitical events, the Netherlands will vote for a new government on November 22. This means that political parties are sharing their plans and participating in various broadcast debates to convince people to go vote for them. An economic topic that is widely discussed is livelihood security. This ranges from discussions whether the minimum wage should be increased to different solutions for the dysfunctional housing market. It is not a new issue, but it gained renewed importance as inflation rose to record levels in 2022.

Household consumption under pressure

Although the official Dutch inflation rate (HICP) was -1% y/y in October (see figure 1), this statistic does not match how consumers currently perceive the increase in prices. In short, this is due to Statistic Netherlands (CBS) changing the calculation methodology for energy price inflation. For various reasons, historical data has not been restated using this new method. This means official statistics now underestimate perceived inflation, when comparing the figures year-on-year. Over the course of the coming year, this issue will automatically be solved. If the new methodology were applied to the historical HICP, the inflation rate in October would have been 6.4%.

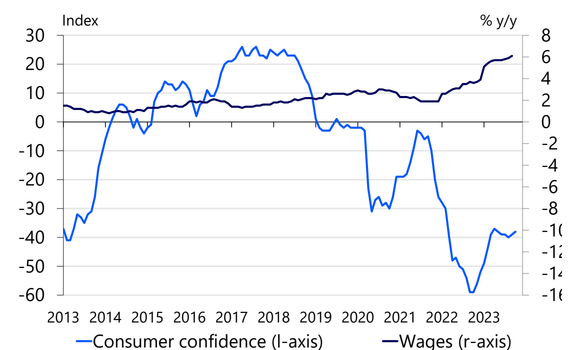
Knowing that the official inflation statistic currently underestimates perceived inflation goes a long way to explain why household consumption declined by 1.6% q/q in the second quarter of this year, despite the lower inflation figures. It also explains why consumer sentiment is still very negative despite wages increasing by 6.1% y/y in September (see figure 2). Consumer confidence did increase slightly to -38 in October from -39 in September, but it remains far below the long-term average. Nonetheless, we do expect household consumption to remain stable for the upcoming quarters as most consumers are still secured of a job, considering the tight labor market.

Figure 1: Official inflation deviates from perceived inflation



Source: Statistics Netherlands and RaboResearch

Figure 2: Consumers confidence and wages



Source: Statistics Netherlands

The economy is slowly cooling down

Even though the labour market remains tight and the unemployment rate is still at a low level, unemployment increased slightly to 3.6% in September (see figure 3). For the coming period we expect that unemployment will continue to rise slightly.

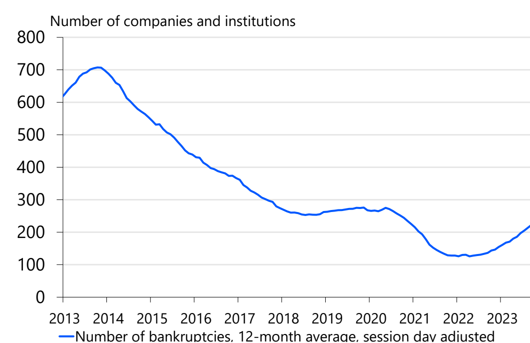
Contributing to the modest rise in unemployment is the increase in bankruptcies (see figure 4). The number of bankruptcies in recent years was very low. Maybe artificially low, as the government supported companies through the Covid period. But now, higher input prices and higher interest rates are leading to higher costs for companies, in turn, causing more bankruptcies. Plus, in July this year, the tax authority started to call in at once debts from taxes that were deferred during the Covid period for companies that had not yet started to repay these debts or made any repayment agreement. This is the case for a small group of companies. Although this might lead to some additional bankruptcies, we think the overall effect will be limited. The increase of both the unemployment rate and the number of bankruptcies reflects that the overheated Dutch economy is slowly starting to cool down.

While the Dutch economy is starting to cool down more generally, there are some differences between sectors. For instance, for the manufacturing sector, we expect that we have already seen the biggest decline in production. Manufacturing production increased quite a bit in the beginning of 2021 and reached its peak in April 2022, which was about 16% higher than the average of 2019. After months of declining since then, manufacturing production has now stabilized and remains slightly above pre-Covid levels. In August 2023, production was about 3% above the 2019 average. Producer sentiment, however, has been slightly negative since August, but increased from -2.2 in August and September to -1.8 in October.

Figure 3: Unemployment rate increased slightly

Source: Statistics Netherlands

Figure 4: Bankruptcies moved further up



Source: Statistics Netherlands

Table 1: Economic forecasts

	2022	*2023*	*2024*	*Q1/23*	*Q2/23*	*Q3/23*	*Q4/23*
GDP	4.3	0.4	0.8	-0.4	-0.2	0.1	0.1
Priv. consumption	6.6	0.5	1.2	-0.2	-1.6	0.2	0.3
Govt. consumption	1.6	2.6	2.4	0.4	0.8	0.6	0.6
Bus. investment	3.9	6.2	-2.8	3.5	2.1	-2.0	-2.0
Govt. investment	-4.7	2.0	5.9	1.9	1.1	1.2	1.2
Exports	4.5	0.6	1.5	0.2	-0.8	0.1	0.1
Imports	3.8	1.6	1.6	0.4	0.3	-0.1	-0.1
HICP (% y/y)	11.6	4.5	2.5				
Unemployment rate	3.5	3.6	3.9				

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United States

Author
Philip Marey
Senior US Strategist
+31 6 138 92 958

Another shutdown on the horizon

The internal leadership fight of the Republicans froze legislation in the House of Representatives for three weeks in October. In the meantime another war broke out, the next deadline for a government shutdown is getting closer and the expired Farm Bill has yet to be renewed. The funding of the federal government expires on November 17, less than three weeks from now. On September 30, in an unexpected and courageous move, House Speaker Kevin McCarthy defied the hardliners in his own Republican party and proposed a stopgap measure (continuing resolution) to extend government funding through November 17 at the $1.6 trillion annual rate of fiscal year 2023. This move averted a government shutdown on October 1, because no agreement had been reached in Congress about the 12 appropriations bills for the new fiscal year. However, it also led to a challenge to McCarthy's position as House Speaker. Matt Gaetz filed a motion to vacate against McCarthy and on October 3 he was removed from his position. It took three weeks for the Republicans to agree on a new House Speaker, but on October 25 Mike Johnson (Louisiana's 4th district) became the new top Republican in the House of Representatives. However, during these three weeks of Republican discord legislation was essentially frozen. Half the time gained by the September 30 government funding extension was squandered by an internal fight. We are now less than three weeks from the next deadline for a government shutdown. Before November 17, the House still has to adopt 8 appropriations bills for fiscal year 2024, and then reconciliation of the House and Senate versions of the 12 appropriations bills has to take place. In fact, there is still no agreement about the level of total federal spending for FY2024.

Reaching agreement in the House and the Senate on all 12 appropriations bills for fiscal year 2024 (which started on October 1, 2023) seems impossible, so Johnson is thinking about a stopgap measure (continuing resolution) extending funding through either mid-January or mid-April, depending on the preferences of the House Republicans. However, the right wing has been fiercely opposed to stopgap measures. Keep in mind, that McCarthy was ousted three weeks ago because he negotiated a stopgap measure to avert a shutdown. However, with one of their own as Speaker, the hard right may be more flexible about a stopgap measure if Johnson makes a good case that this is going to lead to spending cuts where the right would like to see them. A complicating factor for a stopgap measure beyond 2023 is the automatic spending cuts (sequestration) that will kick in in April 2024 if the government is still funded by a stopgap measure by January 1, 2024. This was part of the debt limit deal made last summer. So any stopgap measure beyond April would trigger automatic spending cuts.

Meanwhile, the Biden administration has requested $106 billion in funds for Ukraine, Israel, Taiwan and the US border. While there is bipartisan support for funding Israel's war effort against Hamas, the House Republicans have been skeptical about sending more money to Ukraine. In fact, in September, many House Republicans - including Johnson - voted against $300 million in aid to Ukraine. On October 26, Johnson said he would bring a separate bill funding Israel to the floor. A vote is now expected on Thursday. If the war between Israel and Hamas escalates into a war with Hezbollah and eventually Iran, we could see the Biden administration ask for additional funds in the coming months. Another pressing legislative issue is that the Farm Bill expired at the end of September. Johnson has said that he hopes to pass the next five year Farm Bill in December, but a stopgap measure may be necessary here as well.

MAGA Takeover

While all eyes are on the Middle East and the election for the House speakership has been seen as a distraction, we would like to point out that the Republican establishment has suffered another major defeat against the tactics of the MAGA wing of the party. First, House Speaker Kevin

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McCarthy was ousted after Matt Gaetz filed a motion to vacate. Then, the number 2 House Republican, Steve Scalise beat his right-wing opponent Jim Jordan in a vote among Republicans, but many right wing Republicans refused to support Scalise on the House floor, making it impossible for him to get a majority. After Scalise gave up, Jim Jordan stepped in, but in turn moderate Republicans refused to support him. After a reboot, Mike Johnson was put forward as the new Republican candidate for House Speaker. Prior to his election, he served as the Vice Chairman of the House Republican conference, the number 5 in the hierarchy. However, Johnson is a MAGA Republican who voted against the September 30 deal to avert the shutdown. Nevertheless, moderate Republicans did not have the stomach to drag out the leadership challenge and decided to close ranks with the MAGA crowd.

However, this means that they handed over the speakership to the MAGA wing of the party. Mike Johnson has the most conservative track record of any Republican House Speaker in more than 100 years. At the same time, about 1/3 of House Republicans has an even more conservative voting record. Johnson is both a social conservative and a fiscal conservative. In 2019-2021, he was chairman of the Republican Study Committee, a socially and fiscally conservative caucus (now 156 seats in the House) that always pushes for significant cuts in non-defense spending. Johnson is not formally part of the House Freedom Caucus, but often attends their meetings. In addition, he is a Trump supporter. In Congress, Johnson represented Trump as a House attorney in the first impeachment trial about Trump's attempt to pressure Zelensky to investigate Joe Biden. He also supported Trump's efforts to contest the 2020 presidential election result. Recently, Trump called the new speaker "MAGA Mike Johnson." Before entering the Louisiana House of Representatives in 2015 and then the US House of Representatives in 2017, Johnson worked as a lawyer, representing conservative clients, arguing against abortion rights and gay rights (in particular same-sex marriages), and arguing in favor of a less rigid separation of church and state (including tax credits for a biblical theme park).

With a MAGA Speaker, the government shutdown dynamics may change. Until now, the moderate Republican leadership would first try to score points with right wing House Republicans and voters by taking the fiscal standoff close to or slightly over the deadline. Then they would reach across the aisle and prevent or end a government shutdown. However, now that the right wing is in charge, things might change. Will they be more likely to agree to a stopgap measure when it is proposed by one of their own or is "MAGA Mike Johnson" as vulnerable to the Freedom Caucus as his predecessors?

Table 1: Economic forecasts

	2022	*2023*	*2024*	*Q1/23*	*Q2/23*	*Q3/23*	*Q4/23*
GDP	2.1	2.0	0.2	2.0	2.1	2.0	-2.0
Consumption	2.7	2.2	0.7	4.2	1.7	2.0	0.0
Business inv.	3.9	2.0	-1.0	0.6	6.1	6.0	-10.4
Residential inv.	-10.6	-12.5	-1.5	-4.0	-3.6	-2.0	-5.2
Government	-0.6	2.8	1.6	5.0	3.3	0.8	2.0
Trade	-0.4	0.8	-0.3	0.6	-0.2	-0.3	-0.1
Inventories	0.7	-0.6	0.0	-2.1	-0.1	-0.1	-0.6
CPI (% YoY)	8.0	4.1	3.0				
Unemployment rate	3.7	3.8	4.6				

Note: * Contribution in pp. Source: Rabobank

Canada

Author
Christian Lawrence
Senior Cross-Asset Strategist
+1 929 438 1518

Going nowhere, moving fast

The Bank of Canada left rates on hold at 5.00% at its October 25 policy decision. All 34 analysts surveyed by Bloomberg unanimously expected this, and a no-change decision was fully priced in by the front end of the Canadian curve. While CPI inflation at 3.8% y/y stands well below the peak of 8.1% y/y observed back in July 2022, inflation on a month-on-month basis is not yet slow enough to indicate a swift return to the 2% target. Inflation would need to print around or below 0.2% m/m to reach the 2% y/y target by August and we do not expect that to happen.

The Bank of Canada is faced with resilient inflationary pressures but also with a slowing economy. GDP growth was below expectations for the second quarter of 2023, printing at -0.2% when market surveys anticipated 1.2% growth. Much of this contraction was driven by weak household consumption and idiosyncratic events, such as the forest fires last summer and the public service Alliance of Canada strike. These events aside, the slowdown in household consumption is expected to continue until 2024. Business investment is expected to remain weak as companies respond to tighter credit conditions and higher interest rates before recovering in 2025. The Bank revised down its GDP forecast for 2023 and 2024. The forecast for 2025 was revised up marginally.

Table 1: Bank of Canada July 2023 Monetary Policy Report

	2022		*2023*		*2024*		*2025*	
	Oct'23	Jul'23	**Oct'23**	Jul'23	**Oct'23**	Jul'23	**Oct'23**	Jul'23
CPI Inflation	**6.8**	6.8	**3.9**	3.7	**3.0**	2.5	**2.2**	2.1
GDP growth	**3.4**	3.4	**1.2**	1.8	**0.9**	1.2	**2.5**	2.4
Consumption	**2.5**	2.5	**1.3**	1.5	**0.4**	0.7	**0.9**	1.1
Housing	**-1.1**	-1.1	**-1.1**	-0.8	**0.2**	0.5	**0.7**	0.6
Government	**0.5**	0.5	**0.3**	0.5	**0.6**	0.6	**0.5**	0.4
Business	**0.7**	0.7	**0.2**	0.0	**0.0**	0.1	**0.5**	0.4
Subtotal: DD	**2.6**	2.6	**0.7**	1.2	**1.2**	1.9	**2.6**	2.5
Exports	**0.9**	0.9	**1.6**	1.6	**0.3**	0.0	**0.8**	0.7
Imports	**-2.4**	-2.4	**0.4**	0.4	**-0.6**	-0.7	**-0.8**	-0.7
Subtotal:netX	**-1.5**	**-1.5**	**2.0**	**2.0**	**-0.3**	**-0.7**	**0.0**	**0.0**
Inventories	**2.3**	2.3	**-1.5**	-1.4	**0.0**	0.0	**-0.1**	-0.1

Source: Bank of Canada

Activity in Canada is slowing, but slowly. The deteriorating economic picture may help the inflationary slowdown, but this has been a drawn out process with a period of ultra-low interest rates providing households and corporate Canada with a buffer against the Bank of Canada's monetary policy transmission mechanism. Real yields have risen in response to expectations that policy rates will remain higher for longer, and the term premium has risen due to increased market uncertainty about how high rates will go and how long "longer" really is. This has been boosted by dynamics south of the border where a pronounced bear steepening of the US Treasuries curve feeding through into the Canadian government bond market.

CPI inflation is forecasted to remain high in the short term and we do not expect a return to the 2% target before 2025 – a familiar theme across the North American region. Slowing inflation in 2023 has benefitted from slower growth in prices for non-energy goods and shelter, the prices for non-energy goods being driven primarily by easing supply chains. Inflation in services has been sticky. It is declining albeit a much slower pace than the BoC would like. An essential fact to note here is that real consumption per capita is plateauing, indicating that consumer spending is beginning to respond to monetary policy and that this has potential to drive inflation lower going forward.

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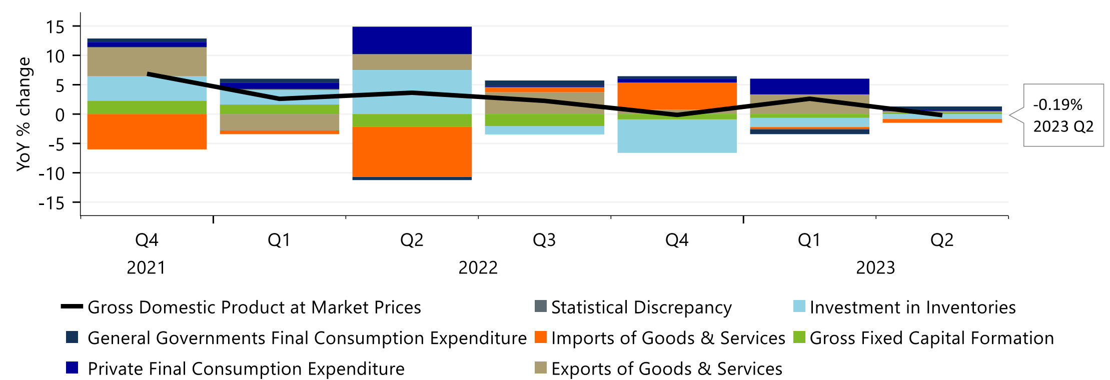
Demand for housing is also starting to soften, though this has yet to be reflected by prices. We will be the first to admit we have been surprised by the resilience of the housing market. Record immigration has probably provided support that we didn't anticipate fully. High energy prices have driven headline inflation, and there is a substantial upside risk that energy prices will rise further driven by the potential escalation of the conflict in the Middle East.

To our mind, and also highlighted by the BoC itself, the main upside risks to inflation are the following: Stronger-than-expected consumer resilience, continued tightness of the labor market, and/or rising energy prices. Despite the "soft-landing" rhetoric, there is still a need to remain cautious. There is potential for over-extended high rates leading to a faster-than-expected economic slowdown as the lagged effects of monetary policy hit the consumer all at once. Record-high levels of household debt paired with record-high interest rates have the potential to drive households to cut back spending drastically. This is a dynamic we had expected to take hold with more effect by this juncture but to our mind, the resilience of the consumer reflects more a timing issue than anything else and we fully expect a marked slowdown heading into 2024.

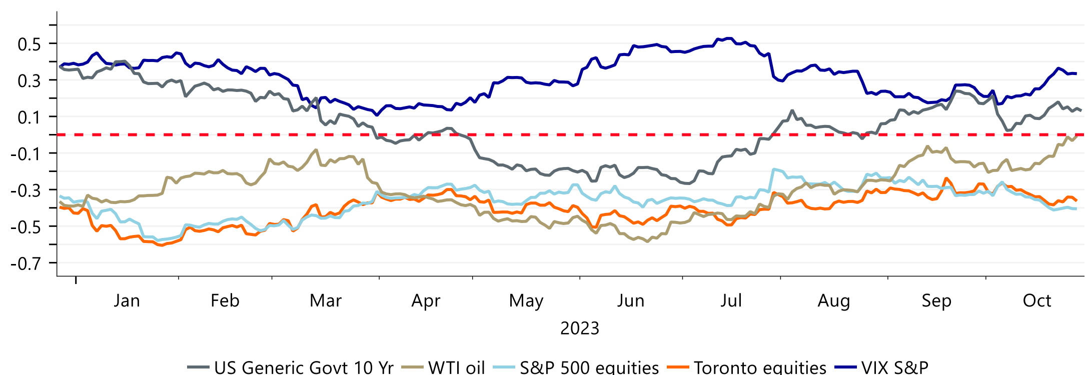
Figure 1: Canadian GDP is slowing and we expect the consumer to come under more pressure



Source: macrobond

Turning to the currency, the 1.33-1.37 range we have been highlighting for USD/CAD has broken to the upside. The appreciation of in USD accelerated in October as a result of the Israel-Hamas conflict. We don't expect much further upside for USD/CAD. Yet, a return to the 1.35 magnet we have been trading around is becoming unlikely to materialize this year. That said, we would suggest the primary driver of USD strength has been the sharp bear steepening of the US Treasuries curve. We cannot rule out further upside for the 10-year yield – which up to this point we would suggest has primarily been a function of rising term premium. However, our rates strategist, Richard McGuire, is calling for a sharp move lower to 4.45% by year-end. Should this come to fruition then a move back below 1.36 could well be on the cards for USD/CAD, and we now forecast an year-end target just north of there at 1.362.

Figure 2: The dramatic bear steepening of the UST curve has boosted USD



Source: Rabobank

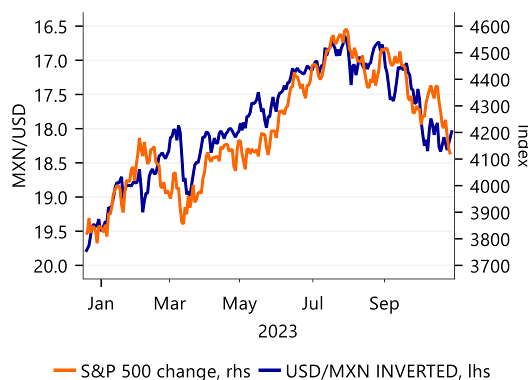
Mexico

Author
Christian Lawrence
Senior Cross-Asset Strategist
+1 929 438 1518

Risk matters

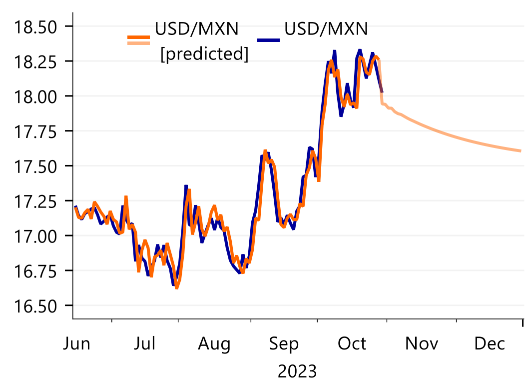
Risk matters. Anyone reading this will be more than aware of that, and it has always been particularly true for the Mexican peso, which has long traded as a risk proxy within the EM FX space. We often discuss this relationship at length as we view it as critical for MXN price action, and the relationship is far from symmetrical or linear and is subject to both the domestic interest rate and broader market regimes. Compounding the role of risk for USD/MXN is that USD is also sensitive to risk given its role as global safe-haven. As a quick recap, MXN is a high-beta currency and its position as the only fully deliverable and convertible LatAm currency makes it vulnerable to acting as a proxy for the region at large. As MXN is also one of the most liquid currencies in the world, it is often treated as a proxy for EM more broadly. That said, the level of domestic interest rates greatly impacts the symmetry of MXN's sensitivity to changes in risk. When Mexican rates are relatively low we tend to find that MXN will sell-off more during risk-off periods than it will rally during risk-on sessions. When interest rates are elevated, like they are now, then MXN tends to benefit more during rising risk appetite than it suffers when the market is seeking safe havens.

Figure 1: Rick unwind weighing on MXN



Source: Macrobond, Rabobank

Figure 2: Short-term Rabo MXN Model



Source: Macrobond, Rabobank

Indeed, there have been periods over the past year when MXN almost looked like a safe haven itself. Almost. But relative to other EM currencies, MXN really has displayed some safe-haven characteristics. Of course, recent price action has seen MXN's status as the second-best performer year-to-date flip to the worst performer since the beginning of September and the second worst in October.

This in itself sends us a message. COP and MXN stood top and second in the best performers year-to-date until the end of August, as we saw unwinding of MXN (and COP) longs. To our mind, however, this is a reflection of carry trade unwinds as players look to lock in profits from the windfall trade of borrowing in a low yielder and buying MXN. It isn't about fresh MXN shorts, and that matters for the likely longevity of the move. We are still of the view that the trigger for the unwind was the bear steepening of the US Treasuries curve, further exacerbated by heightened global risks stemming from the Israel-Hamas war. The rise in 10-year yields weighed on risk assets across the board and while there is risk of another beyond the 5% handle in 10-year Treasury yields, our rates strategist, Richard McGuire, expects a substantial move lower over the coming months with an end of year forecast of 4.45%. Should that come to fruition, then MXN strength is likely to occur in tandem. If the 10yr UST yield remains at current levels, then our short-term MXN model points to a year-end rate of around 17.60. But if the 10 year does move down to 4.45% then we expect USD/MXN to trade down to 17.20. This does mark an upward revision to our forecasts on these pages last month when we expected a return to the 16.60 lows, but since that juncture the Israel-Hamas war began.

Table 1: Rabobank FX Forecasts

Please note the disclaimer at the end of this document.

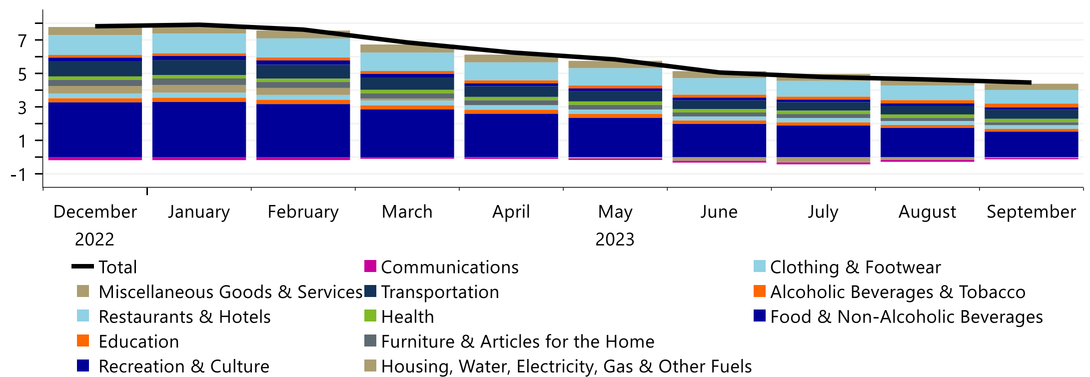
	30-Oct	*1m*	*3m*	*6m*	*9m*	*12m*
USD/MXN	18.0	17.8	17.2	17.8	18.2	18.5
EUR/USD	1.06	1.05	1.02	1.02	1.04	1.05
EUR/MXN	19.1	18.7	17.5	18.2	18.9	19.4

Source: Rabobank

Banxico

Banxico will announce its latest rate decision on November 11 and we full expect the overnight rate to be left on hold at 11.25%. Unlike many other LatAm central banks, we do not expect Banxico to begin cutting rates this year, or even in Q1 of next year. As noted on these pages last month, while Banxico may have been part of the 'LatAm pack' during the tightening cycle, we think Banxico will be more closely linked to the 'North American pack' when the easing cycle begins. The Minutes from the September 28 meeting were released on October 12 and to our mind they support our view that rate cuts are not imminent. Indeed, one member suggested the Bank must avoid premature rate cuts and that eventually rates will need to be cut more slowly, cautioning against rate cuts that are too fast. One member explicitly stated that rates may well be hold beyond Q1 of next year, in line with our thinking.

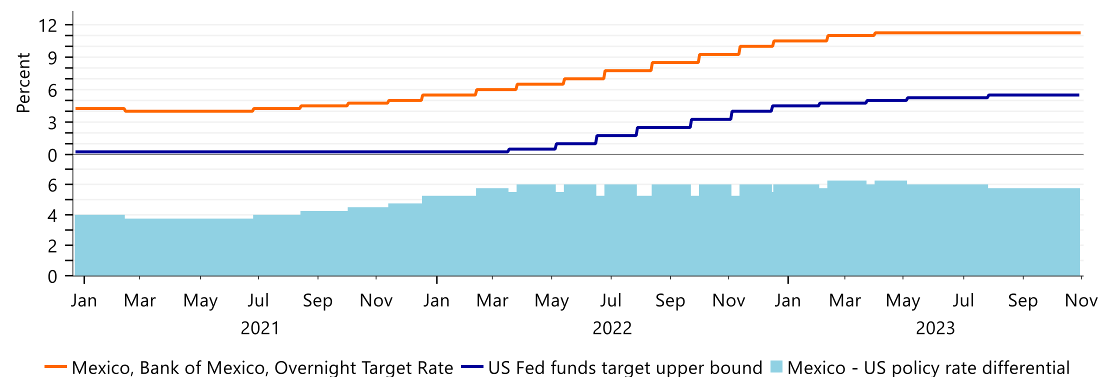
Figure 3: CPI inflation is slowing but we don't expect a return to 3% until 2025



Source: Rabobank, Macrobond

As is the case across the North American region, headline CPI inflation is still high, and core inflation shows persistence. As was noted in the statement that accompanied the meeting, the risks to CPI inflation remain biased to the upside and we don't expect a return to the 3% target until 2025.

Figure 4: Banxico unlikely to cut until the middle of next year



Source: Macrobond

Brazil

Authors
Mauricio Une
Senior Strategist
+55 11 5503 7347

Renan Alves
Strategist
+55 11 5503 7288

Monetary Policy: global scenario raises the bar for deeper cuts

We still see the Copom bringing the Selic rate to 11.75% by end-23 and to 9.25% by end-24. In the latest (November) meeting, the Copom unanimously decided to cut 50bp off the Selic (policy) rate and lower it to 12.25%. This cut was in line with we had expected since the August meeting. This has been the third consecutive cut after the Copom had held the Selic policy rate at 13.75% for almost 12 months, and ahead of central banks in major economies. Other than slightly raising 10bp their inflation projections for end-2024 and end-2025, the Copom also put a great emphasis on how global risks (i.e., higher long-term interest rates in the US, new geopolitical risks, and resilience in high core inflation and labour markets) demand "attention and caution". We interpret not only as raising the bar for cuts deeper than the current pace of 50bp, but also potentially flagging a higher terminal rate than the one (9.0%) we currently envisage. Last but not least, on the domestic front, the Copom reaffirmed the importance for the administration to pursue already established fiscal targets, which contribute to bring to target unanchored inflation expectations (50bp above the target). The slow ongoing disinflationary process still requires a dose of "serenity and moderation" for full reanchoring of inflation expectations.

Fiscal policy: advances in structural reforms

We see the public sector gross debt-to-GDP ratio rising to 76.0% in 2023 and 78.8% in 2024. On 22 August 2023, the Lower House passed the new fiscal framework bill for the president's sanction. The new rules include a looser spending cap that cannot exceed 70% of any revenue gain. It also caps annual spending increases at 0.6% to 2.5% above inflation. On 25 October, Senator Eduardo Braga, the rapporteur for consumption tax (VAT) reform bill unveiled his voting guide recommendations. The previous Lower House approval is the first successful attempt to change the complex tax on goods and services after decades of previous failed attempts. Finally, also on 25 October, the Lower House then passed to the Senate a bill on the taxation of offshore investments and exclusive funds. The approval of this bill is a priority for MinFin Fernando Haddad as he strives to fulfil his goal to reduce Brazil's primary fiscal deficit to zero in the 2024 budget. That said, President Lula declared on 27 Oct that Brazil is not likely to achieve a zero deficit in 2024. The declaration raised investors' concerns as they could indicate that not only the administration lacks the willingness to promote reforms, slowing the ongoing fiscal consolidation. To our minds, we were already counting a slow fiscal consolidation, but we do recognize that this potential signal emerges when global risks keep mounting.

Inflation: despite benign dynamics, risks start clouding the outlook

We forecast CPI inflation at 4.8% y/y in 23Q4 and 3.9% y/y in 24Q4. CPI inflation in September came in at 0.26% m/m and the mid-monthly CPI inflation report for October shows a mere monthly gain of 0.21% m/m. The more intense deceleration of market-set prices, particularly food inflation, more than offsets the faster regulated prices, such as airfare tickets and fuel. Other than food inflation, we also see inflation of industrial goods, services, and underlying services posting benign dynamics. As a result, headline and core inflation—the latter especially—keep slowly receding. That said, we can already notice wholesale prices contributing less to the disinflationary process as commodities prices start to accelerate, backed by the depreciation of the local currency with regards to the greenback. Additionally, the El Niño phenomenon, which we now see as being more likely to occur in 24H1 than in late 23H2, can still add upward pressure on food inflation and energy prices beyond the seasonally higher prices by yearend. Last but not least, a permanent effect of higher fuel prices due to an escalation of the Israel-Hamas conflicts could also challenge the BCB's view that inflation will carry on subsiding in 2024.

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Real activity: a test for resilience

We see GDP growing by 2.8% in 2023 and 1.6% in 2024. The first two quarters in 2023 have surprised to the upside, partly because of the record grain crop in 2023, but also due to higher consumption of services propped up by fiscal pulse. Yet, the lagged effects of higher interest rates of late are starting to become more visible, especially once the contribution of the agricultural sector wanes down. As a result, we expect the economy to decelerate in 23H2. As a matter of fact, high-frequency data show retail sales losing momentum, while the industrial sector keeps facing credit constraints as interest rates remain in restrictive territory despite the recent easing. Going forward, global demand, an essential source of growth for the Brazilian economy, is clouded by tight monetary policy in major economies and by the fragile state of the Chinese economy, while the effect of local monetary easing will only be more clearly felt in 2024. Finally, the eventual adoption of structural reforms, like the consumption tax reform, should only produce output gains in the long run by political design.

Foreign Exchange: heightened risks bring more volatility

We still see the USDBRL at 5.05 by end-2023 and 5.15 by end-2024. Although major central banks have apparently stopped hiking interest rates, this does not mean they are about to cut interest rates. While investors try to discern when a policy rate cut is due amid hawkish messages by major central banks, FX volatility should kick in. On the one hand, heightened global risks tend to drive capitals away from risky assets and towards safe havens. On the other, on the domestic front, the positive discussion in Congress of pragmatic reforms, such as the new fiscal framework and a consumption tax reform, will continue to exert a benign pressure on local risk premia. Moreover, the trade balance is expected to reach a record surplus this year, due to the record agricultural crops this year. Last but not least, we see a current account deficit of -2.0% of GDP in 2023 and -2.2% of GDP in 2024, thanks to the benign harvest in 23H1. On the financing side, we now expect an FDI inflow of 3.4% of GDP in 2023 and 3.3% of GDP in 2024 on the back of tighter global financial conditions.

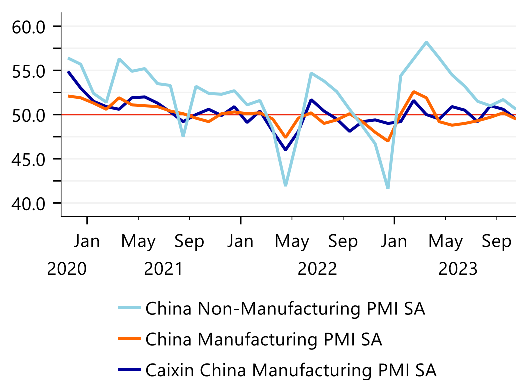
	2022	*2023*	*2024*	*Q1/23*	*Q2/23*	*Q3/23*	*Q4/23*
GDP	2.9	2.8	1.6	4.0	3.4	2.1	1.7
Consumption	4.3	2.7	1.5	3.5	3.0	2.9	1.6
Government	1.5	1.7	1.2	1.2	2.9	1.7	1.2
Investment	0.9	-2.2	3.4	0.8	-2.6	-4.0	-2.8
Exports	5.5	7.0	2.4	7.0	12.1	6.1	2.9
Imports	0.8	2.5	4.7	2.2	2.1	3.3	2.4
CPI (% YoY)	5.8	4.8	3.9	4.7	3.2	5.4	5.1
Selic rate (eop)	13.75	11.75	9.25	13.75	13.75	12.75	11.75
Unemployment rate	9.5	8.0	8.5	8.6	8.3	7.8	7.5

China

Dealing with debt

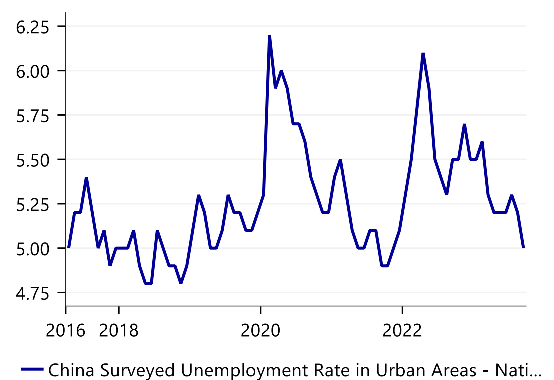
As we outlined in detail in an earlier publication, local government debt levels reached alarming levels in some of China's provinces. While until recently government support and intervention mainly focussed on China's real estate sector, local government debt is now receiving increased attention. As recently as Tuesday the 31st of October, Beijing announced that it will set up a system to tackle debt risks of its local governments. Earlier, China announced that it would execute a 1 trillion yuan debt swap program which would enable local governments to swap their 'hidden debt' for lower yielding bonds. Turning to the system that is going to be set up in order to deal with high levels of government debt, details have been scarce as is often the case when big changes in government policies are initially announced. What is known is that the system will include increased financial supervision and, as such, should be better able to mitigate systemic financial risks. It was also mentioned that China will support the development of state financial institutions. More details might follow.

Figure 1: PMI reports continue to report a rise in unemployment



Bron: Macrobond, Bloomberg

Figure 2: While the official unemployment figures continue to show a decrease.



Bron: Macrobond, Bloomberg

How is the recovery going?

Despite a relatively strong start this year, China's economic recovery slowed significantly during the second quarter of this year. While initially a growth percentage of 0.8% QoQ was reported for the second quarter this was later revised to a disappointing 0.5%. The regular reader knows that this was slightly lower than we expected since we forecasted 0.80% for the second quarter. However, growth during the third quarter of this year growth picked up to 1.3% which is slightly higher than we expected but therefore we can still maintain our annual GDP forecast at 4.8% given that we expect a growth of 1% QoQ for the last quarter. The strong downward revision for the second quarter makes sense given disappointing PMI figures that came out during the same quarter. From April until September the manufacturing PMI was below 50. While the non-manufacturing PMI reached the highest level in March this year, since May 2011 it often has declined rapidly during the second quarter as well. The most recent PMI's also indicate that the recovery remains modest at best with the official PMI's reporting 50.6 and 49.5 for respectively the services- and manufacturing sector. The Caixin manufacturing PMI which came out at 49.5 on 1 November, also indicated that sentiment in the manufacturing sector is seeing a 'renewed deterioration in overall manufacturing conditions'. While it was already expected that the official PMI would deteriorate because of seasonal effects (i.e. due to the lengthy national holiday the Caixin PMI was expected to show a value above 50 because of the different methods that Caixin applies to account for seasonal adjustments). The Caixin PMI report further mentioned that firms registered a fresh fall in production amid slower growth in overall sales mainly due to lower foreign demand. Finally – and in accordance with the official PMI - the Caixin report again

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mentioned that employment across the sector fell. This seems at odds with the most recent unemployment figures released in September which showed that surveyed unemployment decreased from 5.2% to 5%. Taking into account the fact that Beijing also stopped publishing the youth unemployment figures at the moment they reached record highs, this adds to our scepticism regarding the reported unemployment data.

More probes and some green shoots as well?

In the previous monthly we mentioned the EU probe into Chinese state subsidies for the electric car industry and also warned that this should be seen as part of a broader trend of derisking and a changing trade and investment relationship with China. This seems to be confirmed by the fact that the EU is preparing two more probes which will focus on the sector for wind turbines and the steel industry. However, with respect to the probe in China's wind power industry, the EU currently lacks 'very clear evidence' according to EU officials.

However there was also some positive news. Retail sales came in higher than expected (5.5% YoY vs 4.9% expected). Industrial production also came in better with 4.5% YoY growth were 4.4% was expected. This positive news, however, was at least partly offset by a sharp decline in property investments as well as property sales with YoY declines of respectively 9.1% and 3.2%.

What's next?

Taking into account all of the above we still feel very confident about our GDP and USD/CNH forecast. As outlined above and given that we keep our QoQ forecast for the last quarter of this year constant we would still end up with a YoY growth percentage of 4.8% which is slightly lower than the consensus of 5.2%. While the sizable and recently announced stimulus package leads to an upward risk for our forecast, we think it will take some time before these effects will be noticeable in economic data. Having said that, the deteriorating geopolitical landscape holds many downside risks as well. An escalation in the Middle East could also potentially affect China's access to fossil fuels from the Middle East. Furthermore, in case of rising energy prices, Western demand for Chinese exports is likely to decline since it would increase the general costs of living. As such the risks to our forecast seem to be roughly balanced. On the FX side of things we are also still very comfortable with our forecast. At the moment of writing we see a USD/CNH rate of 7.338, close to our Q4 target of 7.35. We also continue to expect a gradual recovery of the renminbi against the dollar since we expect the interest rate differential between the US and China to narrow. Remember that we expect one more modest rate cut for this year of 10 basis points for both the 1-year MLF and the 7-day RRR but that we also expect that this will be the last cut in China's policy rates for the time being. In combination with our Fed forecast that predicts that the Fed will start cutting rates during the second half of next year adds to our expectations of a slow but gradual strengthening of the renminbi for 2024.

Table 1: Economic forecasts

	2022	*2023*	*2024*	*Q1/23*	*Q2/23*	*Q3/23*	*Q4/23*
GDP	2.9	4.8	4.5	2.2	0.5	1.3	1.0
Unemployment (Urban %)	6.2	5.0	5.2	5.3	5.2	5.0	5.0
PBOC 7-day RRR (%)	2.00	1.80	2.00	2.00	1.90	1.80	1.70
PBOC 1-year MLF (%)	2.75	2.55	2.75	2.75	2.65	2.50	2.40
CPI (% y/y)	2.3	0.8	2.0	0.7	0.5	0.4	0.8
USD/CNY	7.25	7.25	7.00	6.90	7.25	7.30	7.35

Source: RaboResearch

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Australia

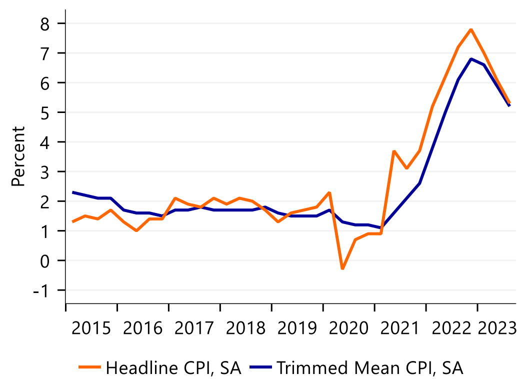
Author
Benjamin Picton
Senior Strategist

Not a very merry Christmas?

Last month we asked the question "which effect dominates?" when comparing resurgent price pressures with softening household consumption and labour markets. In October, we may have got an answer to that question.

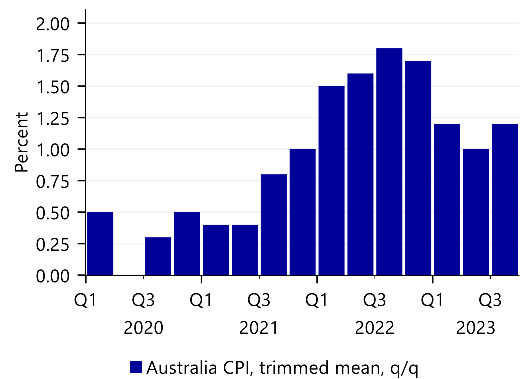
As we expected, the Australian Bureau of Statistics confirmed persistent price pressures by reporting monthly CPI inflation rising from 5.2% y/y in August to 5.6% in September. The more comprehensive quarterly inflation series showed price growth accelerating for the first time since December last year, and accelerating more than most had expected (including the RBA!). Transport fuels led the gains, but there were strong gains in electricity and rents too, despite the introduction of generous new subsidies for both of those categories during the quarter.

Figure 1: Annual inflation rates



Source: ABS, Macrobond

Figure 2: Quarterly inflation

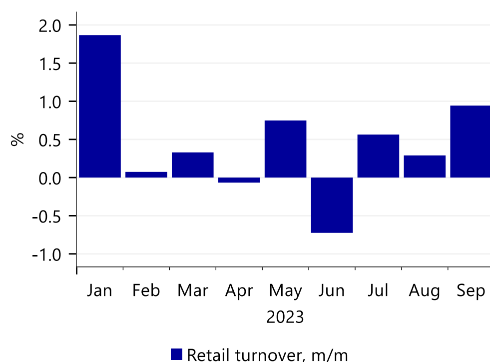


Source: ABS, Macrobond
Note: Inflation rose in Q3 for the first time in 9 months

While the inflation problem got worse, the slowdown in the consumer economy showed signs of bottoming out. Retail turnover figures for September shot the lights out by recording growth of 0.9% in the month versus expectations of just 0.3%. Spending growth was strongest in the most discretionary categories. Department store sales were up 1.7%, and household goods retailing jumped 1.5% in the month. Turnover figures for July and August were also revised higher.

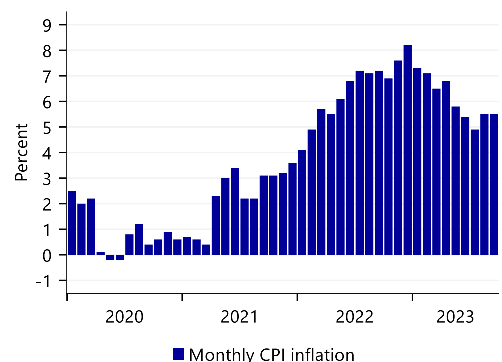
Of course, one swallow does not a summer make, and the strong retail turnover data in September comes at the end of the weakest annual growth in trend terms in the history of the series. The figures are also heavily skewed by growth in prices and growth in population, neither of which is stripped out by the ABS until they publish further detail in early November.

Figure 3: Retail turnover



Source: ABS, Macrobond

Figure 4: Monthly inflation



Source: ABS, Macrobond

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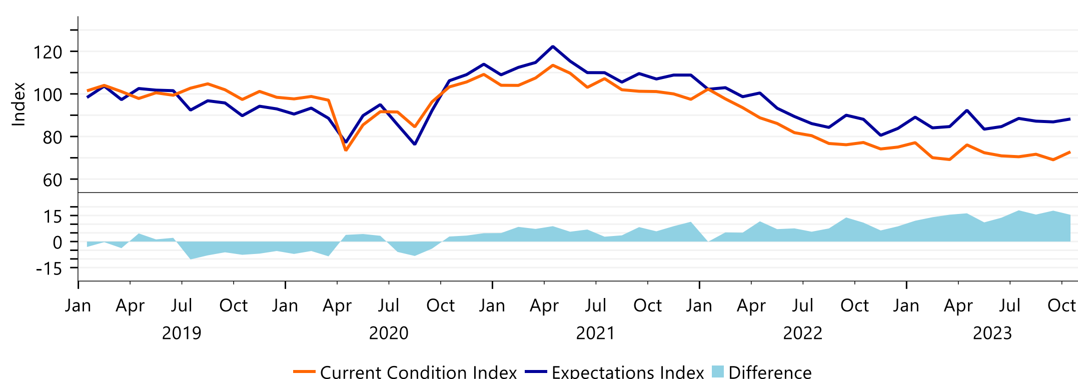
Australia's record high immigration intake may be papering over the fact that many individual households are struggling, but the RBA looks at the economy as a whole, not on a household-by-household basis. New RBA Governor Michele Bullock admitted as much in her recent 'fireside chat' when she responded to a questioner by saying "*we set policy according to aggregates*". With aggregate demand now turning higher, labour markets remaining strong, inflation rising and financial stability risks not posing a major concern, we believe conditions justify the 25bp rate hike in November that we have been forecasting for several months.

Bullock herself laid the groundwork for a resumption in the hiking cycle by saying that the RBA has a "*low tolerance*" for inflation taking longer than forecast to return to the 2-3% target, and that the Bank "*will not hesitate to raise the cash rate further if there is a material upward revision to the outlook for inflation*". We believe the big upside surprise in the third quarter inflation report qualifies as a 'material upward revision' because it makes the RBA's inflation forecasts for 2023 almost impossible to achieve and puts their timeline of a mid-2025 return to the 2-3% target band in serious doubt without further tightening.

Figure 5: Melbourne Institute consumer confidence



Note: The spread between current situation and future expectations remains close to recent highs
Source: Melbourne Institute, Macrobond

More rate hikes may be necessary, but they are certainly not welcome. Australian households remain under a great deal of pressure, as reflected in the Melbourne Institute consumer confidence series. An interesting insight provided by the survey is that the spread between future expectations and current conditions is close to the widest it has been in four years. Australian's seem to think times are tough, but it won't be long before things turn for the better.

A rate hike or two in the lead-up to Christmas would kill that optimism stone dead, and really put a dampener on economic activity. Unfortunately, we think it might be coal in the stocking from the RBA this year.

Table 1: Economic forecasts

	2022	*2023*	*2024*	*Q1/23*	*Q2/23*	*Q3/23*	*Q4/23*
GDP	3.7	1.4	1.6	0.2	0.1	0.3	0.4
Consumption	6.5	1.4	1.2	0.2	-0.1	-0.1	0.5
Business investment	4.2	5.5	2.1	3.4	0.5	0.5	0.6
Government	5.1	1.6	3.6	0.1	0.5	1.1	0.8
Export	3.4	6.8	3.1	1.8	1.2	1.2	0.8
Import	12.7	4.6	4.7	3.2	1.4	1.2	0.6
CPI, % y/y	6.6	5.9	4.0	6.6	6.4	5.7	5.0
Unemployment rate	3.7	3.7	4.1	3.6	3.6	3.8	3.9

Source: RaboResearch

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Forecasts

Table 1: Economic Forecasts

	2022	2023	2024		2022	2023	2024
United States				**Eurozone**			
GDP growth	2.1	2.0	0.2	GDP growth	3.4	0.5	0.5
Inflation rate	8.0	4.1	3.0	Inflation rate	8.4	5.6	3.5
Unemployment rate	3.7	3.8	4.6	Unemployment rate	6.7	6.6	6.6
China				**United Kingdom**			
GDP growth	2.9	4.8	4.5	GDP growth	4.1	0.4	0.0
Inflation rate	2.3	0.8	2.0	Inflation rate	9.1	7.6	3.5
Unemployment rate	n/a	n/a	n/a	Unemployment rate	3.7	4.4	5.5
Brazil				**The Netherlands**			
GDP growth	2.9	2.8	1.6	GDP growth	4.3	0.4	0.8
Inflation rate	5.8	4.8	3.9	Inflation rate	11.6	4.5	2.5
Unemployment rate	9.5	8.0	8.5	Unemployment rate	3.5	3.6	3.9

Source: Rabobank

Table 2: Swap rate forecasts

	2 Nov	3M	6M	12M		2 Nov	3M	6M	12M
USD					**EUR**				
Fed funds target	5.50	5.50	5.50	5.00	ECB depo rate	4.00	4.00	4.00	3.75
SOFR	5.32	5.31	5.31	4.81	ESTR	3.90	3.93	3.95	3.64
3m Libor	5.39	5.40	5.28	4.78	3m Euribor	3.97	3.97	4.04	3.68
2y swap	4.86	4.65	4.30	3.60	2y swap	3.53	3.70	3.60	3.20
5y swap	4.37	4.10	3.70	3.10	5y swap	3.17	3.30	3.10	3.00
10y swap	4.32	4.00	3.75	3.40	10y swap	3.23	3.30	3.10	3.00
30y swap	4.15	3.85	3.65	3.50	30y swap	3.04	3.10	3.00	2.80
CAD					**GBP**				
Overnight target	5.00	5.00	5.00	4.50	Base rate	5.25	5.25	5.25	5.25
3m CDOR	5.06	5.05	5.05	4.38	3m Libor	5.26	5.30	5.25	5.20
2y swap	5.00	5.00	5.00	5.00	2y swap	4.89	5.10	4.90	4.40
5y swap	4.37	4.23	4.05	3.47	5y swap	4.38	4.60	4.20	3.70
10y swap	4.32	4.30	4.18	4.05	10y swap	4.25	4.20	4.00	3.80
20y swap	4.10	4.00	3.90	3.78	30y swap	4.21	4.10	4.00	3.90
MXN					**BRL**				
Overnight rate	11.25	11.25	11.25	10.00	SELIC target	12.25	11.25	10.50	9.50
3m swap	11.53	11.47	11.39	9.89	3m	11.85	11.20	10.60	9.62
2y swap	10.53	10.21	9.62	8.70	2y swap	10.86	10.30	9.98	9.72
5y swap	9.59	9.33	8.90	8.63	5y swap	11.38	10.51	10.21	9.99
10y swap	9.51	9.46	9.18	8.82	10y swap	11.67	11.33	10.87	10.40
30y swap	9.65	9.46	9.20	8.88					

Source: Rabobank

Table 3: FX forecasts

	2 Nov	3M	6M	12M		2 Nov	3M	6M	12M
Majors					**Latin America**				
EUR/USD	1.06	1.02	1.02	1.05	USD/BRL	4.96	5.05	5.05	5.10
GBP/USD	1.22	1.19	1.20	1.21	USD/MXN	17.59	17.20	17.80	18.50
USD/JPY	150.5	148.0	147.0	138.0	**Asia**				
USD/CAD	1.38	1.36	1.36	1.36	USD/CNY	7.31	7.35	7.30	7.25
AUD/USD	0.64	0.62	0.64	0.70					
NZD/USD	0.59	0.58	0.60	0.64					
EUR/CHF	0.96	0.94	0.95	0.95					
EUR/NOK	11.87	11.60	11.30	10.50					
EUR/SEK	11.83	11.40	11.00	10.80					
EUR/DKK	7.46	7.45	7.45	7.45					

Source: Rabobank

RaboResearch
Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts
+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Global

Michael Every
Senior Macro Strategist
Michael.Every@Rabobank.com

Europe

Elwin de Groot
Head Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Bas van Geffen
Senior Macro Strategist
ECB, Eurozone
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Stefan Koopman
Senior Macro Strategist
UK, Eurozone
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Erik-Jan van Harn
Macro Strategist
Germany, France
+31 6 300 20 936
Erik-Jan.van.Harn@Rabobank.nl

Maartje Wijffelaars
Senior Economist
Italy, Spain, Portugal, Greece
+31 88 721 8329
Maartje.Wijffelaars@Rabobank.nl

Americas

Philip Marey
Senior Macro Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Christian Lawrence
Senior Cross-Asset Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Une
Senior Macro Strategist
Brazil, Chile, Peru
+55 11 5503 7347
Mauricio.Une@Rabobank.com

Renan Alves
Macro Strategist
Brazil
+55 11 5503 7288
Renan.Alves@Rabobank.com

Molly Schwartz
Cross-Asset Strategist
+1 516 640 7372
Molly.Schwartz@Rabobank.com

Asia, Australia & New Zealand

Teeuwe Mevissen
Senior Macro Strategist
China
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Benjamin Picton
Senior Macro Strategist
Australia, New Zealand
+61 2 8115 3123
Benjamin.Picton@Rabobank.com

FX Strategy

Jane Foley
Head FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Rates Strategy

Richard McGuire
Head Rates Strategy
+44 20 7664 9730
Richard.McGuire@Rabobank.com

Lyn Graham-Taylor
Senior Rates Strategist
+44 20 7664 9732
Lyn.Graham-Taylor@Rabobank.com

Credit Strategy & Regulation

Matt Cairns
Head Credit Strategy & Regulation
Covered Bonds, SSAs
+44 20 7664 9502
Matt.Cairns@Rabobank.com

Bas van Zanden
Senior Analyst
Pension funds, Regulation
+31 30 712 1869
Bas.van.Zanden@Rabobank.com

Paul van der Westhuizen
Senior Analyst
Financials
+31 88 721 7374
Paul.van.der.Westhuizen@Rabobank.com

Cas Bonsema
Senior Analyst
ABS, Covered Bonds
+31 6 127 66 642
Cas.Bonsema@Rabobank.com

Agri Commodity Markets

Carlos Mera
Head of ACMR
+44 20 7664 9512
Carlos.Mera@Rabobank.com

Michael Magdovitz
Senior Commodity Analyst
+44 20 7664 9969
Michael.Magdovitz@Rabobank.com

Paul Joules
Commodity Analyst
+44 20 7887 824436
Paul.Joules@Rabobank.com

Energy Markets

Joe DeLaura
Senior Energy Strategist
+1 212 916 7874
Joe.DeLaura@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Europe	+31 30 216 9045	Hans.Deusing@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
Adam Vanderstelt	Australia, New Zealand	+61 2 8115 3102	Adam.Vanderstelt@rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Short-term Interest Rates

Marcel de Bever	Global Head	+31 30 216 9740	Marcel.de.Bever@Rabobank.com

Bonds & Interest Rate Derivatives

Henk Rozendaal	Global Head Fixed Income	+31 30 216 9423	Henk.Rozendaal@Rabobank.com

Solutions

Sjoerd van Peer	Global Head	+31 30 216 9072	Sjoerd.van.Peer@Rabobank.com

Relationship Management

Rogier Everwijn	Global Head	+31 30 712 2440	Rogier.Everwijn@Rabobank.com
Rob Eilering	Banks	+31 30 712 2162	Rob.Eilering@Rabobank.com
Petra Schuchard	Insurers		Petra.Schuchard@Rabobank.com
Frank Dekkers	Asset Managers		Frank.Dekkers@Rabobank.com
Javier Alvarez de Eerens	MDB	+31 30 712 1015	Javier.Alvarez@Rabobank.com
Christel Kleinhaarhuis	Fintech		Christel.Klein.Haarhuis@Rabobank.com

Capital Markets

Laura Bijl	Global Head	+31 88 726 3254	Laura.Bijl@Rabobank.com
Christopher Hartofilis	Capital Markets USA	+1 212 808 6890	Christopher.Hartofilis@Rabobank.com
Ian Baggott	Capital Markets Asia	+852 2103 2629	Ian.Baggott@Rabobank.com
Willem Kröner	Global Head ECM	+31 30 712 4783	Willem.Kroner@Rabobank.com
Harman Dhami	DCM Syndicate	+44 20 7664 9738	Harman.Dhami@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

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