September 1st, 2020

BANNOCKBURN

GLOBAL FOREX

September 2020 FX Outlook

The US dollar's rally in the initial phases of the pandemic has been unwound, and sentiment appears to be the most negative since the Great Financial Crisis. New lows for the year against the euro, Swiss franc, the British pound, Swedish krona, and the Australian dollar were recorded in recent weeks. The Dollar Index (DXY), which is heavily weighted toward Europe, fell by over 4% in July, the largest monthly decline in a decade, and another 1.25% in August. In fact, the Dollar Index has not risen on a monthly basis since March. The surge in gold (reached a record high near around $1975 an ounce) was also seen in some quarters as an expression of dollar bearish sentiment.

The interest rate support for the dollar has fallen Of course, with around $14.5 trillion of negative-yielding bonds, mostly in Europe and Japan, the US still offers a premium, but the premium has narrowed, and when hedging costs are included, it has disappeared. Growth differentials also had favored the dollar, but it is not so clear anymore. The eurozone's August Purchasing Managers Survey disappointed, and as the month ended, the virus appears to be growing faster in Europe than the US. Yet, as with the interest rate differentials, growth differentials are simply less dollar supportive, and that is the takeaway.

It is not as if all things were equal. The relevant pre-existing conditions in this context were two-fold. First, after trending higher for several years, by various metrics economists use, the dollar was over-valued prior to the pandemic. At the end of last year, according to the OECD's measure of purchasing power parity (a rough approximation of value in a world of currencies that are no longer backed by gold), the dollar was terribly rich against most of the major currencies. The euro was estimated to be a little more than 26% undervalued against the US dollar Sterling was next, nearly 11% undervalued. The Canadian dollar was almost 9% undervalued, and the Japanese yen was 7% cheap to the greenback. As of June, the Economist's "Big-Mac" model of purchasing power parity had the euro more than 16% undervalued, and sterling was 25% undervalued.

The second pre-existing condition was that growth and interest rate differentials attracted significant portfolio flows into the US. US stocks have outpeformed European shares handily over the past 3, 5, and 10-years. The narrowing of yield differentials means that US Treasuries have outpeformed German, British, and Japanese bonds over the past couple of years. This suggests that many asset managers are overweight US exposure. One estimate (13D Global Strategy and Research) suggested is that there has been "nearly $10 trillion of global capital concentration into US assets in less than a decade."

Still, European stocks (Dow Jones Stoxx 600) outperformed US shares (S&P 500) on the downside in the first three months of the year and has underperformed in the recovery. June was the only month so far this year in which the Stoxx 600 outperformed the S&P 500 (~2.8% to 1.8%). In August, the S&P 500 gained around 7.2%, more than twice the Dow Jones Stoxx 600 3% gain. Year-to-date, the S&P 500 is the only G7 equity market index positive for the year. Equity portfolio investment tends to carry low currency hedge ratios, and the greenback's decline adds a tailwind for dollar-based investors in European markets. The Swedish stock market, for example, performed marginally better for unhedged dollar-based investors than the S&P 500 so far this year (~8.6% vs. 8.2%).

In a nutshell, the dollar's main supports have weakened, it was overvalued, and it was a crowded trade. The adjustment has been nearly relentless. The euro has fallen in only five weeks since the end of April (19 weeks). Speculators in the futures market have amassed record net and gross long euro positions, and still, the biggest pullback has been limited to about 2.5-cents.

Most of the major central banks did not meet in August, and their September meetings will draw attention. Several central banks, including the Federal Reserve, the European Central Bank, and the Bank of Japan, will update their economic forecasts. The Federal Reserve may be the most likely to adjust policy as a follow-up to its formal decision to target the average rate of inflation. Still, on balance, it might not be prepared to move quite yet to cap interest rates or boost it bond-buying, even though Congress has been unable to provide fresh fiscal stimulus. The Fed has not achieved its 2% inflation target since 2012. As of August 25, the Fed's balance sheet was nearly $180 bln (~2.5%) below its peak in mid-June.

Many emergency measures were initially for six months or so, and governments and central banks will face some difficult choices. Most of the Fed's facilities, though used less than anticipated, have been extended until the end of the year. The ECB has extended its Pandemic Emergency Purchase Program. The thrust of monetary policy is shifting from its initial efforts to ensure orderly markets to supporting the recovery.

Without a vaccine, a partial and uneven recovery may be the best that can be expected over the coming months. This means that elevated unemployment levels will prevail, even if partially hidden or socialized through furlough and short-time schemes. Canada has announced both a four-week extension of its emergency income program (through mid-September) before modifying initiatives to put them on a more sustainable basis. It has also extended its loan program for businesses. In Germany, Finance Minister Scholz, who will be the Social Democrat candidate for chancellor next year, has pushed through an extension of its short-term work program (~government picks up about 2/3 of the wages for households with children) for 24 months from 12. France is preparing a large stimulus effort. UK Chancellor Sunak is under increasing pressure to extend funding for the furlough program that is supporting around four million people, but parts of Her Majesty's Treasury is pressing for some funding through new taxation.

That said, with numerous vaccines in various stages of development, optimism is running high. Many governments are relaxing some of the procedures around creating vaccines to expedite the process. Until a vaccine is available of which people can be confident, flare-ups may be unavoidable, but they can be minimized and limited in scope. That will be the challenge in September. As the US flare-up appears to be being brought under control in late August, the contagion is rising in the Asia Pacific region and parts of Europe.

The US-Chinese relationship has deteriorated on many fronts, two issues that had been flashpoints, trade, and currency, have become less so. China has stepped up its imports of US agriculture goods, and with 19 tankers carrying a combined 37 mln barrels of oil from the US (~$1.55 bln), its energy imports will surge in September. Although many observers have emphasized that China is far behind its numerical commitments, top US officials (including Navarro, Lighthizer, and Kudlow) all publicly stated that the agreement was intact, and China was adhering to the deal.

A year ago, the US was citing China as a currency manipulator as the dollar rose above CN7.0. However, the link between the geopolitical competition and the yuan has loosened. The yuan traded at seven-month highs against the dollar at the end of August. Its nearly 2% gain makes it the strongest in the region last month. The JP Morgan Emerging Market Currency Index fell a little more than 0.5% in August, paring July's roughly 2.4% rise. Regionally, South America underperformed, alongside the Turkish lira, which fell to new record lows in August (~-5.2%). After the lira, the next three emerging market currencies were Brazil real (~-4.7%), Argentine peso (-2.5%), and the Chilean peso (~-2.2%).

Currency Outlooks

Dollar

After trending lower since March, the dollar traded weakened broadly in the second half of August. Sentiment remains bearish as growth and interest rate differentials supports have been undermined. Although there has been some impact of the loss of the $600 a week in federal unemployment insurance and the fading effect of other fiscal efforts, the economic data have been mostly better than expected. Estimates for Q3 GDP around a little above 20% at an annualized rate. That said, there is concern that a quarter or more of the jobs there were lost temporarily will turn into permanent losses. The Federal Reserve meets on September 16. The steepening of the yield curve through a relative increase in long-term yields cannot come as a surprise to Fed officials after adopting the average inflation rate target. Yet, on balance, it does not seem quite ready to move to cap rates either through yield curve control or through increased bond buying. The political campaigns get into full swing after Labor Day (September 7). It has yet to become much of a market factor except that investors appear to be buying options for protection, and this is seeing the volatility curve steepen.

Euro

The euro has not been the best performing major currency this year, this quarter, or last month. Its 6.6% advance through the first eight months puts in fourth place within the top ten major currencies against the US dollar. Most of those gains were registered here in Q3, where it is in fifth place. It was appreciated by a little less than 1.5% in August. Speculators have amassed a record net and gross long euro positions in the futures market. The ECB meets on September 10 and is not expected to take new action. The economy has generally performed in line with the staff forecasts last updated in June when it forecast an 8.3% expansion here in Q3. The WTO may announce its preliminary ruling on EU charges that Boeing received illegal government assistance and could be a new flashpoint in the evolution of the trade relationship. In late August, the EU ended its controversial tariff on US lobster in exchange for reduced levies on around $200 mln of EU consumer goods.

(end of March indicative prices, previous in parentheses)

Spot: $1.1935 ($1.1780)

Median Bloomberg One-month Forecast: $1.1905 ($1.1570)

One-month forward: $1.1945 ($1.1785)

One-month implied vol: 7.9% (7.8%)

Yen

The dollar traded between JPY104 and JPY108 in July and a narrower JPY105-JPY107 range in August. On a purely directional view, the yen tends to weaken when US yields rise and/or when the S&P rally. The three-quarter contraction that began in Q4 19 with the sales tax increase and typhoon appears to be ending here in Q3. Prime Minister Abe will step down due to health reasons around the middle of September when the LDP picks his successor. The situation is still fluid, and Cabinet Secretary Suga seems may get the not, which would underscore the continuity we see as the most likely outcome. The Diet's term is up in a year, but the LDP may want a sooner election. While there may be an alternative to Abe, there may not be for Abenomics, which is arguably the traditional policy thrust of the Liberal Democrat Party of loose monetary policy, deficit spending, and raise the consumption tax. A supplemental budget for the second half of the fiscal year (begins October 1) seems more likely that fresh initiatives from the Bank of Japan, which meets on September 17. BOJ Governor Kuroda is seen likely to fulfill his current term, which ended April 2023.

Spot: JPY105.90 (JPY105.85)

Median Bloomberg One-month Forecast: JPY105.95 (JPY106.50)

One-month forward: JPY105.90 (JPY105.90)

One-month implied vol: 7.4% (7.3%)

Sterling

The pound fell by about 6.5% in H1 20 and rebounded by about 7.8% through the first two months of Q3. Sterling made a new marginal high for the year in late August, a little below $1.34 on the back of a softer US dollar. The UK economy shrank by a fifth in Q2, the most in the G7, but appears to be gaining traction, though there is still pressure to extend the employee furlough program. There has been little progress in trade negotiations with the EU. A break-through is needed in the coming weeks in time for the mid-October EU summit and allow members sufficient time to ratify the agreement. This continues to seem unlikely. The potential disruption may already be a factor underpinning implied volatility. Yet, August was the second consecutive month that sterling rose against the euro, and is near its best level in two-and-a-half months at the start of September.

Spot: $1.3370 ($1.3085)

Median Bloomberg One-month Forecast: $1.3285 ($1.2820)

One-month forward: $1.3370 ($1.3090)

One-month implied vol: 8.7% (8.6%)

Canadian Dollar

The Canadian dollar was one of the strongest major currencies in August, appreciating about 2.9% against the US dollar. Rising equities speaks to the elevated risk appetites that are correlated with the Canadian dollar. Rising commodity prices (CRB Index rose about 6.8% in August, its fourth consecutive monthly gain and now is above its 200-day moving average for the first time since January) have also been supportive. Since the middle of March, the US dollar has fallen by about 11.3% against the Canadian dollar, but speculators in the futures market continue to carry a net short futures position. The Canadian dollar is the only major currency that is depreciated against the US dollar this year. A scandal over favoritism and a dispute over fiscal policy led to the resignation of Finance Minister Morneau, but it did not derail the Canadian dollar's recovery. Canada has been more cautious than the US in lifting containment measures while seeing a slightly higher percentage of returning workers. The Bank of Canada meets on September 9 and is not expected to change policy. New fiscal initiatives are likely to be outlined on September 23, when the new session of parliament begins. Ottawa's decision about Huawei, on the one hand, and how to respond to the new US tariffs on Canada's aluminum, on the other hand, risks escalating tensions with both Beijing and Washington.

Spot: CAD1.3045 (CAD 1.3410)

Median Bloomberg One-month Forecast: CAD1.3100 (CAD1.3515)

One-month forward: CAD1.3000 (CAD1.3415)

One-month implied vol: 6.5% (6.3%)

Australian Dollar

The recovery of the Australian economy seemed to lag behind others even before the flare-up that led to the lockdown in Victoria. Australia lost about 375k full-time positions between February and June and only gained 43.5k back in July (~11%). However, the government has reduced the JobKeeper and JobSeeker payments. Still, in the fiscal year that began July 1, the government anticipates a boost in spending and a reduction of tax revenues of around A$185 bln. The Australian dollar gained about 3.3% in August, its fifth consecutive monthly increase, and is up about 5.1% for the year. Reserve Bank Governor Lowe admitted to preferring a weaker currency, but suggest intervention would only be effective if there was a valuation misalignment. The OECD's model of Purchasing Power Parity puts fair value at closer to $0.6950 (~5.7% over-valued), which represents a relatively modest deviation.

Spot: $0.7375 ($0.7145)

Median Bloomberg One-Month Forecast: $0.70315 ($0.7035)

One-month forward: $0.7380 ($0.7150)

One-month implied vol: 9.8% (10.4%)

Mexican Peso

The peso gained about 1.8% against the dollar in August, making it among the strongest of the emerging market currencies. The peso is off around 13% year-to-date, and the substantial depreciation that could still feed through to domestic prices. Consumer prices have firmed in recent weeks and are now at the upper-end of 2%-4% target range. After cutting the overnight rate by 50 bp at the past five meetings to 4.5%, Banxico sees itself with limited scope for additional easing. The next meeting is on September 24, and it will likely standpat. Outside of the auto sector, Mexico's economy is still reeling from the virus and the limited policy response. A new corruption scandal in President AMLO's family may complicate next year's local and state elections, but had little impact on the Mexican peso. The dollar has been trading between MXN21.85 and MXN23.00 since the middle of June. It edged lower to MXN21.74 into the end of the month before bouncing back to nearly MXN22.00 where it finished the month. In the low interest-rate environment, the 4.5% available on short-term Mexican bills (cetes) is attractive and keeps the peso stronger than the macroeconomic considerations would suggest.

Spot: MXN21.89 (MXN22.27)

Median Bloomberg One-Month Forecast: MXN21.92 (MXN22.12)

One-month forward: MXN21.96 (MXN22.37)

One-month implied vol: 13.4% (14.7%)

Chinese Yuan

The recovery of the world's second-largest economy is being stymied by floods and weak domestic demand. The floods are disrupting food supplies and elevating prices. By late August, and estimated $26 bln of damage has been inflicted and four million people displaced. Agriculture imports have been boosted to meet the shortage of domestic supply. Many expect the PBOC to continue to ease policy in a targeted way while holding back from the asset purchases that other major central banks are undertaking. Since late May, the dollar has depreciated by around 4.7% against the Chinese yuan. Chinese officials have allowed the yuan's exchange rate to become decoupled from the ongoing political tension. The yuan strengthened in seven of the nine weeks of Q3 through the end of August to finish near seven-month highs. We suspect there is a limit to how much Beijing will allow the US to depreciate the dollar, but the 1.7% depreciation thus far this year is modest by any measure, and still fits the official rhetoric about the yuan's stability.

Spot: CNY6.8485 (CNY6.9750)

Median Bloomberg One-month Forecast: CNY6.8815 (CNY7.0165)

One-month forward: CNY6.9050 (CNY7.0795)

One-month implied vol: 4.9% (4.4%)

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