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BANNOCKBURN GLOBAL FOREX, LLC

December 2020 FX Outlook

The end of the annus horribilis is at hand, and despite the hard winter ahead for the northern hemisphere, there is a sense of optimism for the new year. The first generation of vaccines for the coronavirus appears promising. The US has elected as president a person who is within the internationalist tradition. The UK's standstill agreement with the EU will still expire at the end of the year, but many are still hopeful a last-minute deal can still be struck. China has entered into the large regional free-trade agreement and allowed the yuan to appreciate by considerably more than even yuan bulls like us imagined. The yuan's year-to-date gain of 6% rival the Bulgarian lev as the top performer among emerging market currencies through November. It will the yuan's first annual increase since 2017 when it appreciated by a little more than 7%.

The prospect that the Covid-19 can be brought under control spurred a shift in portfolio allocation. On the one hand, market breadth increased, and on the other, value overperformed growth. The Russell 2000 in the US rose over 17% last month, easily besting the NASDAQ and S&P 500. Among the major equity markets, Japan is seen as a "value play" as price-to-book multiples are around a third of what they are in the US. Foreign investors have returned to being net buyers here in Q4 (~$16 bln) after having sold around $83 bln of Japanese shares in the first nine months of the year.

The backing up of bond yields that one would expect in the reflation trade has arguable been kept in check by expectations that both the Federal Reserve and European Central Bank will do more to support the bond market at policy meetings in December. The ECB has all but promised to expand and extend its Pandemic Emergency Purchases Program by several hundred billion euros (400-600 bln) and offer new attractive loans at an interest rate of minus 100 bp provided certain lending targets are reached. The Federal Reserve is expected to shift its purchases toward the longer end of the curve. There is some speculation that the Fed may increase the amount of Treasuries it is buying (currently $80 bln of Treasuries and $40 bln Agency mortgage-backed securities a month). Given some official comments, there may not be a majority that favors an increase now.

The prospects of a vaccine that could allow a return to a new normal is seen as negative for the dollar. Those currencies that tend to do well in periods of robust growth, the Antipodeans and Scandis shined in November. The JP Morgan Emerging Markets Currency Index snapped a three-month decline with more than a 1% increase. Rising commodity prices, driven in part by strong Asian demand (especially China), were particularly helpful for Latam currencies. The Colombian peso and Brazilian real were the best performers, up 7.5% and 7.2%, respectively. Turkey's apparent adoption of orthodox monetary policy triggered a short squeeze that lifted around 12% in the first few weeks before the gains were halved after in the second half of the month. Still, its 6.7% gain in November was only the second monthly rise since the end of Q3 19.

Our longer-term view that the dollar's third significant rally since the end of Bretton Woods is over remains intact, and we expect the greenback to decline in 2021 as we expected in 2020. However, more immediately, the US economy's resilience leaves the dollar with scope to firm into the end of the year after its broad decline in November. Still, it is likely to remain rangebound against most of the major currencies as it has since early Q3.

The dollar fell for a sixth consecutive month against the Chinese yuan. Since the yuan is closely managed, its appreciation to new two-year highs is likely because Beijing is accepting it. Officials have taken advantage of its appreciation to ease capital outflow rules, and reduce reserve requirements for foreign exchange forward, and made the setting of the daily reference rate more transparent and predictable.

The large surplus shows the yuan is competitive for trade purposes. Yet, China's integration into the world's capital markets, what we have dubbed the internationalization of the yuan 2.0, requires a stronger yuan, but really one that reflects the reasonable expectations of the managers of the world's savings. China's high-interest rates (3.2%+ on the 10-year bond), perhaps the only G20 economy to expand this year, and the large current account surplus would be associated with an appreciating currency. If it does not materialize, Chinese officials seem to recognize, it would deter global asset managers. Nevertheless, the consolidation and partial trimming of the dollar's November losses suggests some modest gains against the yuan as well ahead of year-end.

Currency Outlooks

Dollar

The macro forces that drive the $6.6 trillion a day foreign exchange market are larger than who occupies the White House. The twin deficits offer a framework to understand the downside pressure on the dollar when growth and rate differentials are less supportive. However, more immediately, the US economy will likely prove more resilient than Europe and Japan. Its social restrictions were introduced later and have generally been milder. This could underpin it into the end of the year. Yet, without at least renewing various income support programs, and the foreclosure and eviction prohibitions, a fiscal cliff could weaken the US economy in Q1 21, just as the eurozone and Japan rebound. The Federal Reserve's last meeting of the year concludes on December 16. It is widely expected to shift its purchases to favor longer-term bonds. There are some economists that warn it could increase the amount of its bond purchases, though we are less sanguine. The failure to extend several of the Fed's emergency facilities into next year may say more about the US political climate than about the central bank's preparedness for another crisis.

Euro

There is little doubt of what the ECB will do when it meets on December 10. It will expand its emergency bond-buying program and extend it through the end of 2021. ECB President Lagarde will likely indicate that the central bank is prepared to do more if necessary. With new social restrictions in place, some of which are likely to extend into December, large parts of the European economy will contract in Q4. The failure of negotiators to reach a new trade accord with the UK could see the euro appreciate against sterling and possibly spill over against the dollar. The euro remains in a $1.16-$1.20 trading range as it has since late July, and while we expect the breakout to be on the topside, it may have to wait until next year for a sustained move. That said, a convincing move above $1.20 gives scope for another two-cent advance.

(end of October indicative prices, previous in parentheses)

Spot: $1.1645 ($1.1645)

Median Bloomberg One-month Forecast: $1.1725 ($1.1725)

One-month forward: $1.1655 ($1.1655)

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

Yen

The dollar successfully tested support around JPY104 in July, September, and October before finally the bears succeeded and took it to about JPY103.20 in early November. Two factors helped the greenback recover and snap the yen's appeal: the end of political uncertainty in the US and the enhanced prospects for vaccines to protect from the coronavirus. The historic rally in equities also dimmed the attractiveness of the safe-haven characteristics of the yen. Even if the lower end of the dollar's range expanded, the upper end has not. The JPY106.00 area still ought to cap dollar bounces. The Japanese government is putting together a third supplemental budget but only about half is seen as new funds. The Bank of Japan meets on December 18 and is not expected to change policy, even though the 2019 sales tax increase has dropped out of the year-over-year comparisons showing deflationary pressures have not been fully arrested.

Spot: JPY104.65 (JPY104.65)

Median Bloomberg One-month Forecast: JPY104.85 (JPY104.85)

One-month forward: JPY105.00 (JPY105.00)

One-month implied vol: 8.0% (8.0%)

Sterling

The process that was started three and a half years ago by a closely decided referendum, which was to be non-binding, the UK will in fact leave the year-long standstill agreement with the EU at the end of December. The key issue that remains at this late date is whether a new trade agreement will be struck. Indeed, the year-end deadline seems to be the only deadline that is sacrosanct. Many continue to expect a last-minute deal suggesting the market reaction could be more dramatic if officials fail. The EU accounts for nearly half of the UK's trade but the UK accounts for around 15-18% of EU's trade. The Bank of England increased its bond-buying program by GBP150 bln in November and is unlikely to take fresh steps at the December 17 meeting. With prospects of a vaccine and some official comments, the market has unwound expectations that the BOE would adopt negative rates next year.

Spot: $1.2950 ($1.2950)

Median Bloomberg One-month Forecast: $1.2975 ($1.2975)

One-month forward: $1.2950 ($1.2950)

One-month implied vol: 11.3% (11.3%)

Canadian Dollar

The Canadian dollar's 2.5% gain last month leaves it flat on the year. Only the Norwegian krone has done worse (~-0.20%) among the majors. The strong risk appetites seen in the booming equities are often associated with an appreciating Canadian dollar. The Toronto Stock Exchange's 10.6% advance last month turned the index positive for the year (~0.8%) and was the largest monthly since April. Oil prices and commodity prices, in general, have risen and this is also often supportive of the Canadian dollar. The new spending measures announced at the end of November will lift the projected deficit to C$381 bln in the fiscal year ending March 31, more than 10% larger than projected in July. The deficit is projected to fall to C$121 bln in the next fiscal year, without including the additional but unspecified stimulus of C$70-C$100 bln cumulative over the next three years, which is proportional to the size of the output gap the central bank expects. Nevertheless, Trudeau's minority government is looking increasingly vulnerable and a snap election early next year has become more likely.

Spot: CAD1.3320 (CAD 1.3320)

Median Bloomberg One-month Forecast: CAD1.3285 (CAD1.3285)

One-month forward: CAD1.3300 (CAD1.3300)

One-month implied vol: 8.3% (8.3%)

Australian Dollar

After setting the high for the year in early September a little above $0.7400, the Australian dollar trended lower through the start of November when it briefly slipped below $0.7000. The optimism over the vaccine, the October jobs surge, other data showing the recovery remains intact, and the broad US dollar weakness helped lift the Australian dollar back to $0.7400 by the end of November. A move above there would immediately target the $0.7500-$0.7550 area. Relations with China, which absorbs around a third of Australia's exports remain strained, even though both are members of the new Regional Comprehensive Economic Partnership, the largest free trade agreement in the world. Since Australia's strategic and defense interests anchor it in the US-sphere, the relationship may be difficult to improve, but Beijing could offer a rapprochement as a modest gesture of good faith to the incoming US administration.

Spot: $0.7030 ($0.7030)

Median Bloomberg One-Month Forecas: $0.7115 ($0.7115)

One-month forward: $0.7030 ($0.7030)

One-month implied vol: 12.0% (12.0%)

Mexican Peso

Driven by relatively high-interest rates, large external surplus, a robust risk-appetite, and a rise in emerging market currencies more broadly, the Mexican peso appreciated by about 5% in November, nearly cutting the year's decline in half. JP Morgan's Emerging Market Currency Index rose by almost 3.7% in November, stopping a three-month slide with its biggest monthly advance in four years. With headline inflation above the upper end of Banxico's 2-4% range, it stood pat in November. Inflation dipped in the first half of November, apparently driven by early year-end sales. Still, most economists expect the central bank to leave its cash target at 4.25% when it meets on December 17. A surprise cut would likely weigh on the peso, but its short-term rates will remain a powerful draw and may limit the peso's downside.

Spot: MXN21.18 (MXN21.18)

Median Bloomberg One-Month Forecast: MXN21.60 (MXN21.60)

One-month forward: MXN21.25 (MXN21.25)

One-month implied vol: 20.5% (20.5%)

Chinese Yuan

The yuan strengthened to new two-and-a-half years highs against the US dollar in November. After appreciating in the first three weeks of last month, it entered a consolidative phase toward the end of November. It culminated a six-month appreciating trend, matching the longest run since 2011. The lower end of the dollar's new range is around CNY6.54 and the upper end may extend toward CNY6.65. The blocking of the Ant (Alibaba's financial arm) IPO, the rash of failures of state-owned-enterprises, and the threat of more sanctions and bans by Trump before he leaves office may be tempering foreign portfolio demand. The early nominations by US President-elect Biden do not suggest that US efforts to resist Beijing's efforts to dominate the South China Sea or its unfair gaming of international trade norms will slacken even if the tactics change.

Spot: CNY6.6915 (CNY6.6915)

Median Bloomberg One-month Forecast: CNY6.7210 (CNY6.7210)

One-month forward: CNY6.7150 (CNY6.7150)

One-month implied vol: 6.6% (6.6%)
