February 4th, 2020

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February 2020 FX Outlook

The global capital markets were roiled in recent weeks by the new virus that jumped species in China. It is contagious during the incubation periods and appears similar though more aggressive than SARS in 2003-2004. And China is larger and significantly more integrated into the global political economy.

The new coronavirus is impactful in several areas outside of the human tragedy. It is a blow to ideas of better growth impulses to start the year. The outlook for China, which had been projected to account for around a sixth of global growth this year, has dimmed. More stimulus is likely to be part of Beijing's answer, as many will recall that the SARS slowed the economy by two percentage points.

Slower growth will make observers more skeptical of China's ability to fully adhere to the new trade agreement with the US that has measurable, quantifiable targets for purchases of broad categories of US goods. Many American observers were critical of the trade agreement on two seemingly incongruent grounds: that it was not severe enough and that China would not be able to achieve the targets. It is almost like Woody Allen's critique of a restaurant that had poor food and small servings.

The outbreak also triggered what arguably is a long overdue unwinding of risk-trades that had spurred significant rallies in equities, emerging markets, and credit. The yen and the Swiss franc and dollar strengthened, but the US Treasuries, as the most liquid and transparent market, remained the safe-haven of choice. US yields fell sharply and the yield curve flattened. Market-based measures of inflation expectations fell as the price of oil collapsed (~-15% in January). Investors moved to fully discount one quarter-point cut by the Federal

Reserve this year and priced in roughly a 60% chance of a second cut, a modest gesture to our non-consensus scenario that had highlighted the risk of two cuts.

On one hand, the dollar has not adjusted as one might expect to the sharp shift in the outlook for US monetary policy. The dollar begins the month looking vulnerable especially against European currencies and the Japanese yen. The Australian dollar's decline may have been exaggerated by the closure of Chinese markets for the extended Lunar New Year holiday, as it is often perceived as a liquid proxy. On the other hand, the dramatic reaction in the bond and equity markets is partly a function of the previous extensive positioning. Yet just as the pendulum of investor psychology overshot on the upside, it is bound to overshoot on the downside, creating new opportunities for investors and businesses.

Investors cannot sustain a high level of anxiety for long. The commercialization of a vaccination, the re-opening of China's markets, and the lifting of the travel bans are steps necessary to rebuild investor confidence and risk-appetites. A large part of China will remain closed until at least February 8, and supply chain disruptions and travel are likely to be disrupted longer. At the same time, most of the G10 central banks do not meet in February, which may dampen the response to high-frequency data, for the most part, in the coming weeks. The exceptions are the Antipodeans (Australia February 3, and New Zealand February 11) and Sweden (February 12).

The UK formally left the European Union, three and a half years after its referendum and entered into a standstill phase. During which time it will negotiate trade agreements with both the EU and the US. The negotiations are off to an inauspicious start as the UK rejects regulatory alignment with the EU and insists the negotiations conclude by the end of the year. Rather than ingratiate itself with the US President Trump, who unlike his predecessors supported Brexit, Prime Minister Johnson has antagonized the US by pressing forward with a digital tax and allowing Huawei a substantial role in its 5G rollout.

Central bank policy gave way to trade concerns as the chief driver of the capital markets in the last part of 2019. The fallout from the new virus China bequeathed the world was the unanticipated driver in recent weeks. Without Federal Reserve, European Central Bank, Bank of Japan, or Bank of England meetings in February to capture investors' attention, after unwinding the extreme risk-off response to the virus, the focus may return to macroeconomic factors.

Currency Outlooks

Dollar

In December, 14 of 17 Federal Reserve officials forecast that no change in monetary policy would likely be necessary this year. Investors' disagreement has grown in recent weeks and accelerated as the deflationary impact of the coronavirus became clear. Interpolating from the fed funds futures, the market has completely discounted one rate cut and has about a 60% of a second move priced into prices at the end of January. The dollar was resilient against most currencies despite the shift until the end of the month when it weakened against European currencies and yen. The output cuts associated with Boeing, and the disruptions emanating from China, will likely be seen quickly in the high-frequency data, with a tepid employment report expected to kick things off. Meanwhile, interest rate differentials continue to move against the US, which we have identified as a late-dollar cycle phenomenon. The US premium over Germany, Japan, and the UK, for example, on both two-year and 10-year borrowings, have been trending down since November 2018 and made new lows in late January.

Euro

While the downside risks in the eurozone appear to have eased, the upside remains muted. German manufacturing remains weak and the demonstrations in France over Macron's latest reform efforts (pensions) has had knock-on effects on French services. Italy has managed to avoid a political crisis, but the economy unexpectedly contracted (-0.3%) in Q4 19 (as did France, -0.1%) and political tensions may return in the spring with the local elections. The German political situation is less precarious as neither the Christian Democrats nor the Social Democrats are prepared to go back to the voters who have repeatedly shunned thems. Within the eurozone, the most significant risk is that the expansion does not gather much strength and the slowing in bank lending to non-financial business is a sign that the European Central Bank's transmission mechanism may be faltering. That said, in late January, the German government revised up their growth forecast for this year to 1.1% from 1.0% projected in October. This is still modest by any reckoning even if nearly twice as fast as 2019's 0.6% pace. Externally, the biggest risk is that trade tensions escalate with the US, and the precise timing is difficult to predict.

(end of January indicative prices, previous in parentheses)

Spot: $1.1093 ($1.1213)

Median Bloomberg Forecast: $1.1147 ($1.1208)

One-month forward: $1.1113 ($1.1235)

One-month implied vol: 4.1% (5.0%)

Yen

The Japanese economy is gradually recovering from the double-whammy in Q4 of the sales tax increase and typhoons. Prime Minister Abe's fiscal stimulus and preparations for the summer Olympics will help give the economy some traction. The yen, however, appears to be driven less by domestic developments and more a function of its role as a funding currency (used levered investors to purchase higher-yielding or more volatile assets). In times of elevated anxiety, as more volatile assets are shunned, the funding currency is bought back. With a handful of exceptions, the dollar has been confined to a JPY108-JPY110 trading range for three and a half months, and that itself is the middle part of the broader three-year JPY105-JPY115 range. The dollar spiked as low as 107.65 on an intraday basis in the first part of January as the US confrontation with Iran sparked fears are a larger conflagration.

Spot: JPY108.35 (JPY108.61)

Median Bloomberg Forecast: JPY108.68 (JPY108.41)

One-month forward: JPY108.00 (JPY108.50)

One-month implied vol: 5.8% (5.4%)

Sterling

The UK economy weakened amid the uncertainty ahead of the December election and the early indications, mostly from sentiment indicators, suggest a strong rebound. This was sufficient to keep the Bank of England on hold in January (7-2 vote for the third consecutive meeting). The central bank assumes the economy stagnated in Q4 (due February 11, after 0.4% growth in Q3). Andrew Baily will replace Carney before the next MPC meeting (March 26), and before then, the government will present its budget, which is expected to formally end the fiscal austerity. The derivatives market still reflects expectations of a rate cut, but not until Q4. Since the UK election on December 13, sterling has been consolidating at lower levels and has averaged about $1.3085. The rate cut scare could not push it much below $1.2965. The high in January was almost $1.3280. A re-test and possible penetration seem likely in February.

Spot:$1.3206 ($1.3257)

Median Bloomberg Forecast: $1.3203 ($1.3238)

One-month forward: $1.3216 ($1.3269)

One-month implied vol: 6.0% (8.2%)

Canadian Dollar

The Bank of Canada held steady last year in the face three rate cuts delivered by the Federal Reserve. However, weaker activity in Q4 19 saw the central bank soften its neutral stance. Still, it does not seem particularly close to cutting rates. Investors seem to favor a cut near mid-year at Governor Poloz's last meeting. Two predecessors, Dodge and Thiessen, both cut rates at their last meetings, perhaps institutionally, protecting the anti-inflation credibility of their successors. The drop in oil prices (~-15% WTI) and commodity prices more generally (CRB Index ~-8.3%), and the risk-off phase saw the Canadian dollar surrender most of December's gains in January and pushed above the 200-day moving average (~CAD1.3230) at the end of January. The CAD1.3400-CAD1.3450 area has blocked stronger US dollar gains over the past six months. The Canadian dollar may be quick to recover when the fear and anxiety breaks.

Spot: CAD1.3237 (CAD 1.2990)

Median Bloomberg Forecast: CAD1.3167 (CAD1.3060)

One-month forward: CAD 1.3200 (CAD1.3000)

One-month implied vol: 4.1% (4.5%)

Australian Dollar

Australia's disastrous fires are reportedly doubling the country's carbon footprint. Coupled with the drought, domestic prices are rising, and the weaker exchange rate may boost imported inflation. On the other hand, the economy has slowed, and the demand from China may underwhelm. The full effects of the three rate cuts in June-October 2019 are still to work their way through the economy, but the unemployment rate fell in both November and December. The Reserve Bank of Australia is one of the few major central banks that meets this month (February 3). The market has grown more confident that the central bank will hold the cash rate at 0.75%. Before the December employment report (January 22), the investors favored a cut. The Aussie's 4.7% loss in January was the largest monthly decline since May 2016. The downside momentum may not be exhausted, but the lows from Q3 19 (~$0.6650-$0.6670) offer important support.   It too appears to be overshooting.

Spot: $0.6692 ($0.7021)

Median Bloomberg Forecast: $0.6798 ($0.6948)

One-month forward: $0.06695 ($0.7027)

One-month implied vol: 7.1% (6.5%)

Mexican Peso

The Mexican peso was one of the strongest currencies last year, appreciating 3.8% against the dollar and is off to a strong start to 2020. Despite the getting caught up in the risk-off spasm, the peso was the second strongest currency in the world in January, with about a 1.2% gain (behind the Indonesian rupiah's 1.7% gain). The peso strength is not a reflection of a healthy economy. In fact, the economy shrank by 0.2% in Q4 19. This was the fourth quarterly contraction in the past five quarters. The peso is strong because investors see a free-lunch. Three-month bills (cetes) pay 7%. The high nominal yields attract the world's savings. Adjusted for inflation, Mexico's real interest rates are high, among the highest in the world. This attracts another set of buyers of Mexican bonds on ideas that real rates are too high and choking the economy. The central bank has been cutting interest rates gradually, four-times since July 2019. It meets again on February 13 and is likely to deliver another 25 bp rate cut to bring the target rate to 7%. There may be scope for another 75 bp of rate reductions this year.

Spot: MXN 18.8450 (MXN18.9265)

Median Bloomberg Forecast: MXN18.9747 (MXN 19.0332)

One-month forward: MXN18.9250 (MXN18.9150)

One-month implied vol: 7.6% (6.5%)

Chinese Yuan

Chinese markets have been closed for an extended Lunar New Year holiday from January 24 to February 3. The coronavirus is a negative shock, and that means lower equities, lower yields, and a weaker yuan, all things being equal. There is likely to be formal and informal policy support. The SARS virus (2003-2004) may have reduced Chinese growth by around two percentage points, A markdown in China's growth prospects may curtail its ability to reach its targeted purchases of US goods. Is force majeure acceptable? The dollar had fallen to almost CNY6.84 before the crisis, which seemed to be an overreaction to the trade truce and the US dropping its August 2019 claim of currency manipulation. A move back above CNY7.0 seems like a reasonable and politically acceptable development.

Spot: CNY6.9109 (CNY6.9632)

Median Bloomberg :Forecast: CNY6.9562 (CNY6.9951)

One-month forward: CNY7.0050 (CNY6.9652)

One-month implied vol: 3.9% (3.9%)