FX View: What to expect in 2020?

The slight growth optimism walking into 2020 has been offset by rising geopolitical tensions between US and Iran last week. It is difficult to predict how and when these tensions will de-escalate. The political imperatives of an election year for President Trump could cut both ways. To take a cynical view, a war has in the past bolstered re-election prospects for incumbents, engaging in conventional warfare would go against Trump's policy of having fewer American boots on the ground (the recent sudden exit from Syria is a case in point). Iran is way below the US's pay-grade when it comes to its military power – be it the air-force, navy or army. Thus Iran's options are really limited to what is termed now "asymmetric" warfare – terror strikes, cyber-attacks and ultimately the dreaded nuclear option. Trump's retaliation in threatening to attack Iranian "heritage' sites seems a new facet of unconventional conflict.

While there would, we hope, considerable efforts from world leaders to defuse the tension, one wonders who really is in a position to bell the cat. Europe looks a trifle exhausted with France effectively left to do the heavy lifting. How much can it lift? On the other hand comments in the Western press suggest that the US attack has led to a consolidation of anti-American sentiment across the region particularly among the Shiite population in the middle-east. The role of the liberal section who until recently had been vociferous in their opposition to the Iranian regime has suddenly dissipated.

This, alas, has the makings of a prolonged conflict, unpredictable in its sudden manifestations and could keep markets volatile. Therefore, we are building in a temporary premium for safe haven assets (JPY, dollar, treasuries) and expect riskier assets (EM currencies including INR) to remain under pressure in the short term. That said, geopolitics is difficult to predict and we could well see the US and Iran arrive at a rapprochement and the market pendulum swing from risk-off to risk-on.

Therefore, once the dust settles, fundamentals could take over. So looking beyond the recent risk aversion, assuming that there is no further escalation on the geopolitical front, we try and make sense of where assets are headed in 2020.

After a turbulent ride in 2019, fundamentally EM assets look better positioned for 2020. Major risks like the US-China trade war, Brexit, and a sharp slowdown in global growth have somewhat abated. That said, these risks have not vanished and are likely to linger on in 2020 – but perhaps not with the same intensity. On the balance, while there are risks, there are also some supports – Old & New -- in the form of loose global monetary policy, EM growth performing better than DMs, yield differential between EMs & DMs, and some resolution on the trade war -- that could favour EM assets.

In the DM space, dollar strength is likely to continue atleast in H1 but the tide could turn by the second half of the year with some of the G7 currencies particularly the EUR gaining some ground against the USD barring some risk-off episodes. The GBP however has its own battles to fight as it manages Brexit.

HDFC Bank Quarterly Forecasts (period end)

	FY20	FY21			
	Mar-20	**Jun-20**	**Sep-20**	**Dec-20**	**Mar-21**
USD/INR	**71.50-73.0**	**71.50-72.50**	**70.50-71.50**	**70.0-71.0**	**70.0-71.0**
GBP/USD	1.30-1.35	1.32-1.34	1.32-1.34	1.30-1.32	1.30-1.32
EUR/USD	1.11-1.13	1.12-1.14	1.14-1.16	1.14-1.16	1.16-1.18
USD/JPY	108-110	109	111	112	112
USD/CNY	6.95-7.05	6.90-7.0	6.90-7.0	6.90-7.0	6.90-7.0

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EM rally could continue in 2020

Emerging market (EM) portfolios including all asset classes have added 11 trillion USD to investor wealth and at the end of 2019 they were valued at roughly 25 trillion USD. However, these gains have not been linear. In 2018 for instance, the emergence of the so-called Trump trade saw a vicious sell off in EMs assets. There was recovery in 2019 with both equities and bonds gaining --MSCI Inc.'s equities gauge rose 9.6% and its gauge of currencies (JP Morgan EM currency index) was up 1.4%.

<u>The recent run-ups in EM asset markets might call for a correction but the consensus view seems to be that the recovery will sustain in 2020 as the underlying supports remain in place.</u> The most critical of these factors is loose monetary policy both in the DM and EM universe that is likely to continue. For one thing, the growth outlook in non-US DMs remains dismal and while data has been mixed, US growth could moderate going forward. The risks around US-China trade war have abated for now but are likely to be an underlying risk to growth even in 2020, warranting both monetary and fiscal support across economies. Global inflation will remain benign barring the event-driven and occasional supply-shocks in key commodities like crude oil.

- **US economy – recession avoided but slowdown on the cards:** More specifically US growth is likely to come off from levels of 2.2-2.4 per cent in 2019 to 1.6 to 1.7 in 2020. The deceleration will reflect the fading effect of tax-cuts and a Fed monetary stance that has turned out to be less dovish than expected but the US economy is far from entering a recessionary down-cycle. While a strong USD and retaliation from China and Europe will weigh on export growth, protection has also meant less imports resulting in a narrowi current account deficit that reduces the external demand drag on GDP. The US consumer is likely to do the heavy lifting with consumer demand remaining the key support.
- **EM growth could improve at the margin or atleast hold up:** Going by consensus forecasts EM growth is likely to improve albeit at the margin from around 3.8 -4.0 per cent to 4.0 to 4.2 per cent. This is partly contingent on stabilising growth in China and in its supply chain economies on the back of stimulus but more substantively on some recovery in economies like Brazil, Mexico, Turkey and India.

- **However, we remain cautious over China's growth prospects:** While we forecast growth to flat-line in the 5.5-6.0 per cent in our base case, we recognize that there are significant risks to the downside. China faces cross-winds of weak export growth as the effects of US trade barriers begin to bite while domestic stimulus attempts to bump growth up.

- **EM central banks to remain accommodative:** EM central banks went well ahead of the curve in cutting rates in 2019. While the bulk of easing appears to be over, the consensus is that some more policy easing is due in a number of the EMs. This is likely to be viewed as additional support for growth as the markets wait for the effect of the 2019 cuts to be reflected in headline numbers.

- **Yield differential between EMs an DMs to support flows into EM assets:** The copy-book inverse relationship between local rates and currency value is unlikely to play out in this case. Yield differentials between EMs and DMs remain high along with a large wedge in growth rates. <u>**This calls for some upside or at least stability in most EM currencies in 2020. For currencies like the INR that could stray from the pack and remain under pressure in H1, the extent of depreciation could be limited by this broader EM-positive sentiment.**</u>

- **The Curious case of the dollar - Significant dollar correction (weakness) to remain elusive in H1, implying the gains in EM currencies could be capped:** Markets have been calling for a correction in the overvalued dollar over the last two years but the relative strength of the US economy, risk related to the trade war and a less dovish than expected Fed have meant that the dollar has held on to its gains. Unless there is a material improvement in the global outlook, we do not see USD weakness at least in 1H 2020 in itself as any significant contributor to EM currency gains. Broad-based USD weakness has and is likely to remain elusive. The Fed's shift in stance from a trigger policy rate cutter to a more cautious, data-driven monetary authority albeit on the dovish side of thing along with its somewhat pleasing fundamentals (a tight labour market without concomitant price pressures) still constitutes a strong case for some USD bidding. Moreover, the continued uncertainty around the US-China trade war, after the signing of the Phase 1 deal, could fuel some safe haven demand for the dollar. That said, we do expect some USD softness in 2H particularly if growth numbers surprise to the downside and the Fed expresses concern about this weakness.

- **Degree of divergence between EM currencies could reduce:** The rise in the EM currency bond index masks large variations within the basket. Taking two extreme cases, the Russian Rouble appreciated by 11.2 per cent in 2019 while the Brazilian Real shed 5.4 per cent. Two things have happened since then. First, economies facing a slowdown have responded with countercyclical measures. Second, the market perception is that in most cases, these measures are working. The implication of this could be that even if there is divergence in currency movement within the broad basket, the degree of this divergence would be less. Again for the INR, that is likely to remain under pressure, this "convergence in divergence" could limit the extent of the depreciation.

- **Markets likely to reward EM's with strong fundamentals:** Currency markets have in the past rewarded economies that have embarked on structural reform or have favourable macroeconomic balances. Some like the RBL were rewarded for Russia's large current account surplus. The BRL could gain on the back of the Brazilian government's progress on pension reform and more reforms that are likely. Thailand and Vietnam have attracted capital that has exited China.

- **EM Rotation from bonds to equities possible:** Going by asset-manager surveys, EM valuations do not look appear overstretched for any of the major asset classes. The possibility of some rotation from bonds to equities is possible. For currencies this rotation remains neutral since overall flows remain unaffected. However, it could impact local yields. For India that faces a fiscal and over- borrowing risk, this could add to some upward pressure on yields particularly at the long end of the curve.

INR-Odd one out?

- *Currency markets are likely to be a little cautious about bundling India together with the list of markets that are getting their act together. There is, for one, considerable concern about a fiscal overrun for 2019-20. There is also a growing fear that there are deep structural issues that underpin its weak GDP numbers apart from a cyclical slowdown. Were this indeed the case, monetary policy would be of help only in addressing the cyclical element of the slowdown. Some sections of the market appear to believe that either structural reforms are inadequate or (like the GST and bankruptcy code) will have enduring implementation niggles.* **The INR underperformed many of its EM peers last year and unlike say the BRL that is likely to catch up with the median, the INR is likely to trade with a depreciation bias at least in 1H 2020, particularly in Q12020.**

- *The February 1 2020 budget remains the key event to watch for. While some fiscal slippage is likely priced in already, there is a clear risk of either a larger than anticipated (our sense is that this is 3.8 per cent of GDP for the central government) deficit or accounting artifices to contain the deficit that would only add to the long term fiscal drag. The softness in the INR over the past few days could spill over into January effectively baking the fiscal risk into the exchange rate. If this "pricing in" happens in the run-up to the budget, the actual event might actually be followed by a small rally.*

- *We see 73.0 as the top for the USD/INR pair in our baseline. However, in the event of any unexpected spikes in oil prices on account of geopolitical tensions or risk-off episodes led by escalation in the trade war, we cannot rule out* *the possibility of the pair intermittently breaching this upper bound and deviating from its fair value (between 71-72/$ as per the REER) in the year. For our baseline forecast, we have assumed Brent crude to average at 65$/bbl. for the year compared to an average of 64$/bbl. in 2019. Barring the recent spike in oil prices which is purely due to pricing in of a geopolitical risk premium, the fundamentals of the oil market continue to suggest no major upside pressure on oil prices for 2020 for now.*

- *A major influence on the USD/INR pair in 2019 was the movement in the CNY. However, we find that this relationship has been asymmetric with a greater influence of the CNY on the INR when the former was depreciating than when it was appreciating. We expect this trend to continue in 2020 with gains in the CNY not translating equally into gains in the INR against the USD. We see a strong resistance at 70.50 for the USD/INR pair for most part of the year.*

Global Market Movers: Trade war, US elections and more

- **US-China trade spat unlikely to go away:** While the vagaries of geopolitics will drive volatility in the markets, some sources of volatility might abate giving way to others. In our baseline scenario, the china-US trade spat is unlikely to resolve fully but negotiations will progress incrementally but in a positive direction, a fact that financial markets now seem to have priced in. **We believe that as long as this conflict remains on slow burn, China will not attempt to devalue the Yuan aggressively to keep the peace with the US. Besides its large external borrowings will also hold it back. We see the CNY is a 6.95 to 7.05 range for most the year.**

- **Watch out for US elections:** The pride of place for volatility drivers will then go to the impending US elections at the end of 2020. Again in our baseline scenario we assume either a second term for Trump or at least a centrist Democrat to take charge of the White House. However, we see a non-trivial risk of a left-of centre democrat to either take a lead in the primaries or to be the next US resident. **Of these candidates, increasing prospects for Elizabeth Warren whose agenda is to curb the power of both big businesses and Wall Street and make fiscal policy more redistributive is perhaps the biggest risk for the financial markets.**

- **Major central banks to remain accommodative:** The fragile growth outlook across the DM world means that major central banks are likely to keep monetary policy loose in 2020. In the US, with the need for “insurance cuts” fading, **the Fed** is likely to remain on hold in our baseline scenario, after having cut rates by 75bps in 2019. However, in the event of any escalation in the US-China trade war (that derails the growth momentum), the central bank could be persuaded to cut once again during the middle of the year. Bottom line is that the probability of a rate cut is higher than a rate increase by the Fed in 2020.

- Elsewhere, **the ECB** is likely to be more dovish and continue its second round of quantitative easing till the end of 2020 and beyond while keeping its deposit rate in the negative territory at -0.5%. **The Bank of Japan** is also likely to maintain status quo, keeping its policy rate unchanged at -0.1% in 2020. The recent fiscal stimulus package announced by the government and with JBP yields within the central bank’s target range the urgency towards cutting rates or providing any further significant stimulus has moderated for now. That said, escalation in the US-China trade war or a sharp appreciation in the safe haven Yen could nudge the BoJ to ease rates further. Finally, for **the Bank of England** the possibility of a rate cut in 2020 is higher and depends on how the Brexit situation unfolds. We expect the BoE to cut by 25bps in H2 2020 from the current rate of 0.75%.

- **Currency Outlook:** As argued above, we expect the EM currency pack to broadly gain against the USD in 2020. In the DM pack as well, the EUR and the GBP are likely to claw back some lost ground as uncertainty around brexit moderates and growth comes off its low in the Eurozone, supported by monetary stimulus. For the JPY we expect the currency to gradually depreciate against the USD through the year driven by a drop in safe haven demand and an accommodative BoJ.

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